

1992

# AICPA Professional Standards: U.S. Auditing Standards as of June 1, 1992

American Institute of Certified Public Accountants

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# **AICPA PROFESSIONAL STANDARDS**

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## **Volume 1**

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**U.S. Auditing Standards**

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**Attestation Standards**

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**As of June 1, 1992**

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***AICPA***

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**American Institute of Certified Public Accountants**



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# **AICPA PROFESSIONAL STANDARDS**

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## **Volume 1**

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**U.S. Auditing Standards**

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**Attestation Standards**

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**As of June 1, 1992**

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*Published for the*  
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# HOW TO USE VOLUME 1

## Scope of Volume 1

This volume, which is a reprint of volume 1 of the looseleaf edition of *AICPA Professional Standards*, includes the currently effective pronouncements on professional standards issued by the American Institute of Certified Public Accountants (AICPA).

## How This Volume Is Arranged . . .

The contents of this volume are arranged as follows:

### **Statements on Auditing Standards and related Auditing Interpretations**

Introduction

The General Standards

The Standards of Field Work

The First, Second, and Third Standards of Reporting

The Fourth Standard of Reporting

Other Types of Reports

Special Topics

Compliance Auditing

Special Reports of the Committee on Auditing Procedure

### **Statements on Standards for Attestation Engagements and related Attestation Engagements Interpretations**

Attestation Standards

Financial Forecasts and Projections

Reporting on Pro Forma Financial Information

## How to Use This Volume . . .

The arrangement of material is indicated in the general table of contents at the front of the volume. There is a detailed table of contents covering the material within each major division.

### AUDITING (UNITED STATES)

The major divisions are divided into sections, each with its own section number. Each paragraph within a section is decimally numbered. For example, AU section 210.04 refers to the fourth paragraph of section 210, *Training and Proficiency of the Independent Auditor*.

Auditing Interpretations are numbered in the 9000 series with the last three digits indicating the section to which the Interpretation relates. Interpretations immediately follow their corresponding section. For example, Interpretations related to section 311 are numbered 9311 which directly follows section 311.

There are six appendixes related to auditing standards as follows:

Appendix A provides the historical background for the present Statements on Auditing Standards.

Appendix B is a list of Statements on Auditing Procedure Nos. 1-54, Statements on Auditing Standards, Statements on Standards for Attestation Engagements, and Statement on Standards for Accountants' Services on Prospective Financial Information issued to date.

Appendix C provides a list of sources of sections in the current text.

Appendix D indicates sections and paragraphs of the text cross-referenced to Auditing Interpretations.

Appendix E provides a list of AICPA Audit and Accounting Guides and Statements of Position.

Appendix F provides a schedule of changes in Statements on Auditing Standards since the issuance of Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures, Nos. 33 through 54*.

A topical index is provided for the Auditing division, and is identified as AU Topical Index.

### ATTESTATION ENGAGEMENTS

Statements on Standards for Attestation Engagements, Statement on Standards for Accountants' Services on Prospective Financial Information and Attestation Engagements Interpretations appear with the prefix AT in their section numbers. Attestation Engagements Interpretations are numbered in the 9000 series with the last three digits indicating the section to which the Interpretation relates. Interpretations immediately follow their corresponding section. For example, Interpretations relating to section 100 are numbered 9100 which directly follows section 100.

A topical index is provided for this division and is identified as AT Topical Index.

### Topical Index . . .

The topical indexes use the key word method to facilitate reference to the pronouncements. The indexes are arranged alphabetically by topic and refers the reader to major divisions, sections, and paragraph numbers.

### Master Topical Index . . .

The Master Topical Index, appearing on the following pages, includes the major headings from each one of the indexes in *AICPA Professional Standards*. The letter citations refer the reader to the index in which the major headings are used.

Indexes are cited in the volumes as follows:

	<u>Citation</u>
Auditing (United States)	AU
Attestation Engagements	AT
Accounting and Review Services	AR
Code of Professional Conduct	ET
Bylaws	BL
Accounting (International)	AC
Auditing (International)	AU
Consulting Services	CS
Tax Practice	TX

A search for information by subject heading may begin either (1) at the level of the Master Topical Index to identify the individual indexes which contain detailed entries on the subject or (2) at the level of the detailed topical index related to the subject.

### Reference Abbreviations . . .

References to *AICPA Professional Standards* use the same citations as listed in the Master Topical Index.

The abbreviation AC, excluding the AC 9000 series which refer to International Accounting Standards, is used to indicate references to the *Accounting Standards—Current Text* published by the Financial Accounting Standards Board. The *Current Text* contains an abridged version of the currently effective financial and reporting standards as amended to date. Quotations of accounting standards in this volume are derived from the original pronouncements and may have been editorially changed in the *Current Text*.

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## AU Section 100

# STATEMENTS ON AUDITING STANDARDS - Introduction

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*Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Conduct requires adherence to the applicable generally accepted auditing standards promulgated by the Institute. It recognizes Statements on Auditing Standards as interpretations of generally accepted auditing standards and requires that members be prepared to justify departures from such Statements.*

*The staff of the Auditing Standards Division has been authorized to issue Interpretations to provide timely guidance on the application of pronouncements of the Auditing Standards Board. Interpretations are reviewed by members of that Board. An Interpretation is not as authoritative as a pronouncement of the Auditing Standards Board, but members should be aware that they may have to justify a departure from an Interpretation if the quality of their work is questioned.*

... responsibilities and functions of independent auditor ... generally accepted auditing standards ... quality control standards ...

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## AU Section 110

### ***Responsibilities and Functions of the Independent Auditor***

Source: SAS No. 1, section 110.

Issue date, unless otherwise indicated: November, 1972.

.01 The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present fairly, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his audit has been made in accordance with generally accepted auditing standards. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and to identify those circumstances in which such principles have not been consistently observed in the preparation of the financial statements of the current period in relation to those of the preceding period.

#### **Distinction Between Responsibilities of Auditor and Management**

.02 The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for adopting sound accounting policies and for establishing and maintaining an internal control structure that will, among other things, record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements. The internal control structure should include an accounting system to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. The entity's transactions and the related assets and liabilities are within the direct knowledge and control of management. The auditor's knowledge of these matters is limited to that acquired through the audit. Thus, the fair presentation of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility. The independent auditor may make suggestions about the form or content of the financial statements or draft them, in whole or in part, based on information from management's accounting system. However, the auditor's responsibility for the financial statements he has audited is confined to the expression of his opinion on them.

[Paragraph amended to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

## Professional Qualifications

.03 The professional qualifications required of the independent auditor are those of a person with the education and experience to practice as such. They do not include those of a person trained for or qualified to engage in another profession or occupation. For example, the independent auditor, in observing the taking of a physical inventory, does not purport to act as an appraiser, a valuer, or an expert in materials. Similarly, although the independent auditor is informed in a general manner about matters of commercial law, he does not purport to act in the capacity of a lawyer and may appropriately rely upon the advice of attorneys in all matters of law.

.04 In the observance of generally accepted auditing standards, the independent auditor must exercise his judgment in determining which auditing procedures are necessary in the circumstances to afford a reasonable basis for his opinion. His judgment is required to be the informed judgment of a qualified professional person.

## Detection of Fraud

[.05—.08] [Superseded January 1977 by Statement on Auditing Standards No. 16, as superseded by section 316.]

## Responsibility to the Profession

.09 The independent auditor also has a responsibility to his profession, the responsibility to comply with the standards accepted by his fellow practitioners. In recognition of the importance of such compliance, the American Institute of Certified Public Accountants has adopted, as part of its Code of Professional Conduct, rules which support the standards and provide a basis for their enforcement.

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## AU Section 150

# ***Generally Accepted Auditing Standards***

Sources: SAS No. 1, section 150; SAS No. 43.

Issue date, unless otherwise indicated: November, 1972.

.01 Auditing standards differ from auditing procedures in that “procedures” relate to acts to be performed, whereas “standards” deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken. *Auditing standards* as distinct from *auditing procedures* concern themselves not only with the auditor’s professional qualities but also with the judgment exercised by him in the performance of his audit and in his report.

.02 The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants are as follows:

### *General Standards*

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

### *Standards of Field Work*

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

### *Standards of Reporting*

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

.03 These standards to a great extent are interrelated and interdependent. Moreover, the circumstances which are germane to a determination of whether one standard is met may apply equally to another. "Materiality" and "audit risk" underlie the application of all the standards, particularly the standards of field work and reporting.\*

.04 The concept of materiality is inherent in the work of the independent auditor. There should be stronger grounds to sustain the independent auditor's opinion with respect to those items which are relatively more important and with respect to those in which the possibilities of material misstatement are greater than with respect to those of lesser importance or those in which the possibility of material misstatement is remote. For example, in an entity with few, but large, accounts receivable, the accounts individually are more important and the possibility of material misstatement is greater than in another entity that has a great number of small accounts aggregating the same total. In industrial and merchandising enterprises, inventories are usually of great importance to both financial position and results of operations and accordingly may require relatively more attention by the auditor than would the inventories of a public utility company. Similarly, accounts receivable usually will receive more attention than prepaid insurance.

.05 The consideration of audit risk has an important bearing on the nature of the audit.\* Cash transactions are more susceptible to irregularities than inventories, and the work undertaken on cash may therefore have to be carried out in a more conclusive manner without necessarily implying a greater expenditure of time. Arm's-length transactions with outside parties are usually subjected to less detailed scrutiny than intercompany transactions or transactions with officers and employees, where the same degree of disinterested dealing cannot be assumed. The effect of internal control structure on the scope of an audit is an outstanding example of the influence on auditing procedures of a greater or lesser degree of risk of misstatement; i.e., the more effective the internal control structure, the less the degree of control risk.

## **Services Other Than Examinations of Financial Statements**

.06 In addition to audits of financial statements, the ten generally accepted auditing standards, to the extent that they are relevant in the circumstances, apply to all other services governed by Statements on Auditing Standards unless the Statement specifies otherwise. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

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\* Editor's Note: See section 312, *Audit Risk and Materiality in Conducting an Audit*.



**AU Section 161*****The Relationship of Generally Accepted Auditing Standards to Quality Control Standards***

(Supersedes Statement on Auditing Standards  
No. 4, *Quality Control Considerations for a Firm of  
Independent Auditors*)<sup>1</sup>

**Source:** SAS No. 25.

**Issue date, unless otherwise indicated:** November, 1979.

.01 The independent auditor is responsible for compliance with generally accepted auditing standards in an audit engagement. Rule 202 [ET section 202.01] of the Rules of Conduct of the Code of Professional Conduct of the American Institute of Certified Public Accountants requires members to comply with such standards when associated with financial statements.

.02 A firm of independent auditors also needs to comply with generally accepted auditing standards in conducting an audit practice. Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance of conforming with generally accepted auditing standards in its audit engagements. The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.

.03 Generally accepted auditing standards relate to the conduct of individual audit engagements; quality control standards relate to the conduct of a firm's audit practice as a whole. Thus, generally accepted auditing standards and quality control standards are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of individual audit engagements and the conduct of a firm's audit practice as a whole.

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<sup>1</sup> The elements of quality control identified in SAS No. 4 have been incorporated in the body of Statement on Quality Control Standards 1, [QC section 10], *System of Quality Control for a CPA Firm*, issued by the AICPA Quality Control Standards Committee—the senior technical committee of the Institute designated to issue pronouncements on quality control standards.

**AU Section 200**

# THE GENERAL STANDARDS

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. . . nature of standards . . . training and  
proficiency of auditor . . . independence . . .  
performance of work . . .

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**AU Section 201*****Nature of the General Standards***

Source: SAS No. 1, section 201.

Issue date, unless otherwise indicated: November, 1972.

.01 The general standards are personal in nature and are concerned with the qualifications of the auditor and the quality of his work as distinct from those standards which relate to the performance of his field work and to his reporting. These personal, or general, standards apply alike to the areas of field work and reporting.

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## AU Section 210

### ***Training and Proficiency of the Independent Auditor***

Sources: SAS No. 1, section 210; SAS No. 5.

Issue date, unless otherwise indicated: November, 1972.

.01 The first general standard is:

The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

.02 This standard recognizes that however capable a person may be in other fields, including business and finance, he cannot meet the requirements of the auditing standards without proper education and experience in the field of auditing.

.03 In the performance of the audit which leads to an opinion, the independent auditor holds himself out as one who is proficient in accounting and auditing. The attainment of that proficiency begins with the auditor's formal education and extends into his subsequent experience. The independent auditor must undergo training adequate to meet the requirements of a professional. This training must be adequate in technical scope and should include a commensurate measure of general education. The junior assistant, just entering upon an auditing career, must obtain his professional experience with the proper supervision and review of his work by a more experienced superior. The nature and extent of supervision and review must necessarily reflect wide variances in practice. The auditor charged with final responsibility for the engagement must exercise a seasoned judgment in the varying degrees of his supervision and review of the work done and judgment exercised by his subordinates, who in turn must meet the responsibility attaching to the varying gradations and functions of their work.

.04 The independent auditor's formal education and professional experience complement one another; each auditor exercising authority upon an engagement should weigh these attributes in determining the extent of his supervision of subordinates and review of their work. It should be recognized that the training of a professional man includes a continual awareness of developments taking place in business and in his profession. He must study, understand, and apply new pronouncements on accounting principles and auditing procedures as they are developed by authoritative bodies within the accounting profession.

.05 In the course of his day-to-day practice, the independent auditor encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to audit and report upon the financial statements of a business because, through his training and experience, he has become skilled in accounting and auditing and has acquired the ability to consider objectively and to exercise independent judgment with respect to the information recorded in books of account or otherwise disclosed by his audit. [As amended July, 1975 by Statement on Auditing Standards No. 5.]

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## AU Section 220

### *Independence*

Source: SAS No. 1, section 220.

Issue date, unless otherwise indicated: November, 1972.

.01 The second general standard is:

In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

.02 This standard requires that the auditor be independent; aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. However, independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.

.03 It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To *be* independent, the auditor must be intellectually honest; to be *recognized* as independent, he must be free from any obligation to or interest in the client, its management, or its owners. For example, an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased. Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.

.04 The profession has established, through the AICPA's Code of Professional Conduct, precepts to guard against the *presumption* of loss of independence. "Presumption" is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests. Insofar as these precepts have been incorporated in the profession's code, they have the force of professional law for the independent auditor.

.05 The Securities and Exchange Commission has also adopted requirements for independence of auditors who report on financial statements filed with it that differ from the AICPA requirements in certain respects. [As modified, November 1979, by the Auditing Standards Board.]

.06 The independent auditor should administer his practice within the spirit of these precepts and rules if he is to achieve a proper degree of independence in the conduct of his work.

.07 To emphasize independence from management, many corporations follow the practice of having the independent auditor appointed by the board of directors or elected by the stockholders.

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## AU Section 230

### ***Due Care in the Performance of Work***

Sources: SAS No. 1, section 230; SAS No. 41.

Issue date, unless otherwise indicated: November, 1972.

.01 The third general standard is:

Due professional care is to be exercised in the performance of the audit and the preparation of the report.

.02 This standard requires the independent auditor to perform his work with due care. Due care imposes a responsibility upon each person within an independent auditor's organization to observe the standards of field work and reporting. Exercise of due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the audit.

.03 A paragraph appearing in *Cooley On Torts* often cited by attorneys in discussing due care merits quotation here:

Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.

.04 The matter of due care concerns what the independent auditor does and how well he does it. [As amended, April 1982, by Statement on Auditing Standards No. 41.] (See section 339.)

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## AU Section 300

# THE STANDARDS OF FIELD WORK

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... auditor's appointment and planning ... planning and supervision ... audit risk and materiality ... substantive tests prior to balance-sheet date ... predecessor and successor auditors ... errors and irregularities ... illegal acts by clients ... internal control structure ... internal audit function ... reports on the processing of transactions by service organizations ... communication of internal control structure ... evidential matter ... analytical procedures ... confirmation process ... receivables and inventories ... long-term investments ... client representations ... related parties ... using work of specialist ... inquiry of client's lawyer ... working papers ... entity's continued existence ... auditing accounting estimates ... audit sampling ... communication with audit committees ... omitted procedures after report date ...

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## AU Section 310

# ***Relationship Between the Auditor's Appointment and Planning***<sup>\*</sup>

Sources: SAS No. 1, section 310; SAS No. 45.

Issue date, unless otherwise indicated: November, 1972.

.01 The first standard of field work is:

The work is to be adequately planned and assistants, if any, are to be properly supervised.

.02 Aspects of supervising assistants are discussed in section 210, *Training and Proficiency of the Independent Auditor*, and section 311, *Planning and Supervision*. Aspects of planning the field work and the timing of auditing procedures are discussed in section 311 and section 313, *Substantive Tests Prior to the Balance-Sheet Date*. [As amended August 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

## **Appointment of the Independent Auditor**

.03 Consideration of the first standard of field work recognizes that early appointment of the independent auditor has many advantages to both the auditor and his client. Early appointment enables the auditor to plan his work so that it may be done expeditiously and to determine the extent to which it can be done before the balance-sheet date. [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

## **Appointment of Auditor Near or After The Year-End Date**

.04 Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, he should ascertain whether circumstances are likely to permit an adequate audit and expression of an unqualified opinion and, if they will not, he should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion. Sometimes the audit limitations present in such circumstances can be remedied. For example, the taking of the physical inventory can be postponed or another physical inventory can be taken which the auditor can observe. (See section 331.09—13.)

## **Timing of Audit Work**

[.05—.09] [Superseded August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

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[The next page is 229.]

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<sup>\*</sup> [Title amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

## AU Section 311

### ***Planning and Supervision***

Sources: SAS No. 22; SAS No. 47; SAS No. 48.

See section 9311 for interpretations of this section.

Effective for periods ending after September 30, 1978, unless otherwise indicated.

.01 The first standard of field work requires that “the work is to be adequately planned and assistants, if any, are to be properly supervised.” This section provides guidance to the independent auditor conducting an audit in accordance with generally accepted auditing standards on the considerations and procedures applicable to planning and supervision, including preparing an audit program, obtaining knowledge of the entity’s business, and dealing with differences of opinion among firm personnel. Planning and supervision continue throughout the audit, and the related procedures frequently overlap.

.02 The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel. For purposes of this section, (a) firm personnel other than the auditor with final responsibility for the audit are referred to as *assistants* and (b) the term *auditor* refers to either the auditor with final responsibility for the audit or assistants.

### **Planning**

.03 Audit planning involves developing an overall strategy for the expected conduct and scope of the audit. The nature, extent, and timing of planning vary with the size and complexity of the entity, experience with the entity, and knowledge of the entity’s business. In planning the audit, the auditor should consider, among other matters:

- a. Matters relating to the entity’s business and the industry in which it operates (see paragraph .07).
- b. The entity’s accounting policies and procedures.
- c. The methods used by the entity to process significant accounting information (see paragraph .09), including the use of service organizations, such as outside service centers.
- d. Planned assessed level of control risk. (See section 319.)
- e. Preliminary judgment about materiality levels for audit purposes.
- f. Financial statement items likely to require adjustment.
- g. Conditions that may require extension or modification of audit tests, such as the risk of material errors or irregularities or the existence of related party transactions.
- h. The nature of reports expected to be rendered (for example, a report on consolidated or consolidating financial statements, reports on

financial statements filed with the SEC, or special reports such as those on compliance with contractual provisions).

[As amended, December, 1983, by Statement on Auditing Standards No. 47.] (See section 312.10.) [As amended, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

**.04** Procedures that an auditor may consider in planning the audit usually involve review of his records relating to the entity and discussion with other firm personnel and personnel of the entity. Examples of those procedures include:

- a. Reviewing correspondence files, prior year's working papers, permanent files, financial statements, and auditor's reports.
- b. Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity.
- c. Inquiring about current business developments affecting the entity.
- d. Reading the current year's interim financial statements.
- e. Discussing the type, scope, and timing of the audit with management of the entity, the board of directors, or its audit committee.
- f. Considering the effects of applicable accounting and auditing pronouncements, particularly new ones.
- g. Coordinating the assistance of entity personnel in data preparation.
- h. Determining the extent of involvement, if any, of consultants, specialists, and internal auditors.
- i. Establishing the timing of the audit work.
- j. Establishing and coordinating staffing requirements.

The auditor may wish to prepare a memorandum setting forth the preliminary audit plan, particularly for large and complex entities.

**.05** In planning his audit, the auditor should consider the nature, extent, and timing of work to be performed and should prepare a written audit program (or a set of written audit programs). An audit program aids in instructing assistants in the work to be done. It should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit. The form of the audit program and the extent of its detail will vary. In developing the program, the auditor should be guided by the results of his planning considerations and procedures. As the audit progresses, changed conditions may make it necessary to modify planned audit procedures.

**.06** The auditor should obtain a level of knowledge of the entity's business that will enable him to plan and perform his audit in accordance with generally accepted auditing standards. That level of knowledge should enable him to obtain an understanding of the events, transactions, and practices that, in his judgment, may have a significant effect on the financial statements. The level of knowledge customarily possessed by management relating to managing the entity's business is substantially greater than that which is obtained by the auditor in performing his audit. Knowledge of the entity's business helps the auditor in:

- a. Identifying areas that may need special consideration.
- b. Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the organization.

- c. Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage of completion of long-term contracts.
- d. Evaluating the reasonableness of management representations.
- e. Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.<sup>[1]</sup>

.07 The auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. Such matters include, for example, the type of business, types of products and services, capital structure, related parties, locations, and production, distribution, and compensation methods. The auditor should also consider matters affecting the industry in which the entity operates, such as economic conditions, government regulations, and changes in technology, as they relate to his audit. Other matters, such as accounting practices common to the industry, competitive conditions, and, if available, financial trends and ratios should also be considered by the auditor.

.08 Knowledge of an entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of personnel of the entity. Working papers from prior years may contain useful information about the nature of the business, organizational structure, operating characteristics, and transactions that may require special consideration. Other sources an auditor may consult include AICPA accounting and audit guides, industry publications, financial statements of other entities in the industry, textbooks, periodicals, and individuals knowledgeable about the industry.

.09 The auditor should consider the methods the entity uses to process accounting information in planning the audit because such methods influence the design of the internal control structure. The extent to which computer processing is used in significant accounting applications,<sup>2</sup> as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, in evaluating the effect of an entity's computer processing on an audit of financial statements, the auditor should consider matters such as—

- a. The extent to which the computer is used in each significant accounting application.
- b. The complexity of the entity's computer operations, including the use of an outside service center.<sup>3</sup>
- c. The organizational structure of the computer processing activities.
- d. The availability of data. Documents that are used to enter information into the computer for processing, certain computer files, and other evidential matter that may be required by the auditor may exist only for a short period or only in computer-readable form. In some computer systems, input documents may not exist at all because information is directly entered into the system. An entity's data retention policies may require the auditor to request retention

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<sup>[1]</sup> Footnote deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

<sup>2</sup> Significant accounting applications are those that relate to accounting information that can materially affect the financial statements the auditor is auditing. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

<sup>3</sup> See section 324, *Reports on the Processing of Transactions by Service Organizations*, for guidance concerning the use of a service center for computer processing of significant accounting applications. [Footnote revised, June 1992, by issuance of Statement on Auditing Standards No. 70.]



of some information for his review or to perform audit procedures at a time when the information is available. In addition, certain information generated by the computer for management's internal purposes may be useful in performing substantive tests (particularly analytical procedures).<sup>4</sup>

- e. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures.<sup>5</sup> Using computer-assisted audit techniques may also provide the auditor with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the auditor to analyze certain data or test specific control procedures without computer assistance.

[New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.10 The auditor should consider whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the internal control structure policies and procedures, or to design and perform audit procedures. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.<sup>6</sup> [New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

## Supervision

.11 Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, keeping informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion among firm personnel. The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work. [Formerly paragraph .09, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.12 Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform. They should be informed of matters that may affect the nature, extent, and timing of procedures they are to perform, such as the nature of the entity's business as it relates to their

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<sup>4</sup> Section 329, *Analytical Procedures* provides guidance pertaining to such procedures. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

<sup>5</sup> See the AICPA Audit and Accounting Guide *Computer-Assisted Audit Techniques* for guidance relating to this specialized area. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

<sup>6</sup> Since the use of a specialist who is effectively functioning as a member of the audit team is not covered by section 336, *Using the Work of a Specialist*, a computer audit specialist requires the same supervision and review as any assistant. [Footnote added by issuance of Statement on Auditing Standards No. 48.]

assignments and possible accounting and auditing problems. The auditor with final responsibility for the audit should direct assistants to bring to his attention significant accounting and auditing questions raised during the audit so that he may assess their significance. [Formerly paragraph .10, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.13 The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report. [Formerly paragraph .11, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.14 The auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit. Such procedures should enable an assistant to document his disagreement with the conclusions reached if, after appropriate consultation, he believes it necessary to disassociate himself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented. [Formerly paragraph .12, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

### **Effective Date**

.15 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this section provides for practices that may differ in certain respects from practices heretofore considered acceptable, this section will be effective for audits made in accordance with generally accepted auditing standards for periods ending after September 30, 1978. [Formerly paragraph .13, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

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[The next page is 231-7.]

## AU Section 9311

### ***Planning and Supervision: Auditing Interpretations of Section 311***

#### **1. Communications Between the Auditor and Firm Personnel Responsible for Non-Audit Services**

**.01 Question**—Section 311, *Planning and Supervision*, paragraph .04(b), lists the following procedure that an auditor may consider in planning an audit: “Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity”.

**.02** What specific things should the auditor consider in performing this procedure?

**.03 Interpretation**—The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity’s financial statements or the performance of the audit, for example, tax planning or recommendations on a cost accounting system. If the auditor decides that the performance of the non-audit services or the information likely to have been gained from it may have implications for his audit, he should discuss the matter with personnel who rendered the services and consider how the expected conduct and scope of his audit may be affected. In some cases, the auditor may find it useful to review the pertinent portions of the work papers prepared for the non-audit engagement as an aid in determining the nature of the services rendered or the possible audit implications.

[Issue Date: February, 1980.]

#### **[2.] Planning Considerations for an Audit of a Federally Assisted Program**

[.04—.34] [Withdrawn March, 1989.]

#### **3. Responsibility of Assistants for the Resolution of Accounting and Auditing Issues**

**.35 Question**—Section 311, *Planning and Supervision*, paragraph .14, states, “The auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit.” What are the responsibilities of assistants when there are disagreements or concerns with respect to accounting and auditing issues of significance to the financial statements or auditor’s report?

**.36 Response**—Rule 201 of the Code of Professional Conduct [ET section 201.01] states that a member shall “Exercise due professional care in the performance of professional services.” The discussion of the third general standard states that “due care imposes a responsibility upon each person within an independent auditor’s organization to observe the standards of field work and reporting.” The first general standard requires assistants to meet the responsibility attached to the work assigned to them.

.37 Accordingly, each assistant has a professional responsibility to bring to the attention of appropriate individuals in the firm, disagreements or concerns the assistant might have with respect to accounting and auditing issues that he believes are of significance to the financial statements or auditor's report, however those disagreements or concerns may have arisen. In addition, each assistant should have a right to document his disagreement if he believes it is necessary to disassociate himself from the resolution of the matter.

[Issue Date: February, 1986.]

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[The next page is 231-17.]

**AU Section 312*****Audit Risk and Materiality in Conducting an Audit\****

Source: SAS No. 47.

Effective for audits of financial statements for periods beginning after June 30, 1984, unless otherwise indicated.

.01 This section provides guidance on the auditor's consideration of audit risk and materiality when planning and performing an audit of financial statements in accordance with generally accepted auditing standards. Audit risk and materiality affect the application of generally accepted auditing standards, especially the standards of field work and reporting, and are reflected in the auditor's standard report. Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

.02 The existence of audit risk is recognized by the statement in the auditor's standard report that the auditor obtained "reasonable assurance" about whether the financial statements are free of material misstatement.<sup>1</sup> Audit risk<sup>2</sup> is the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated.<sup>3</sup>

.03 The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles,<sup>4</sup> while other matters are not important. The phrase "present fairly, in all material respects, in conformity with generally accepted accounting principles" indicates the auditor's belief that the financial statements taken as a whole are not materially misstated.

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\* This section has been amended to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

<sup>1</sup> For purposes of this section, misstatements includes both errors and irregularities as defined in section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraphs .02—.03.

<sup>2</sup> In addition to audit risk, the auditor is also exposed to loss or injury to his professional practice from litigation, adverse publicity, or other events arising in connection with financial statements that he has audited and reported on. This exposure is present even though the auditor has performed his audit in accordance with generally accepted auditing standards and has reported appropriately on those financial statements. Even if an auditor assesses this exposure as low, he should not perform less extensive procedures than would otherwise be appropriate under generally accepted auditing standards.

<sup>3</sup> This definition of audit risk does not include the risk that the auditor might erroneously conclude that the financial statements are materially misstated. In such a situation, he would ordinarily reconsider or extend his auditing procedures and request that the client perform specific tasks to reevaluate the appropriateness of the financial statements. These steps would ordinarily lead the auditor to the correct conclusion. This definition also excludes the risk of an inappropriate reporting decision unrelated to the detection and evaluation of misstatements in the financial statements, such as an inappropriate decision regarding the form of the auditor's report because of an uncertainty or limitation on the scope of the audit.

<sup>4</sup> The concepts of audit risk and materiality are also applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles; references in this section to financial statements presented in conformity with generally accepted accounting principles also include those presentations.

.04 Financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles. Misstatements result from misapplications of generally accepted accounting principles, departures from fact, or omissions of necessary information.

.05 When reaching a conclusion as to whether the effect of misstatements, individually or in the aggregate, is material, an auditor ordinarily should consider their nature and amount in relation to the nature and amount of items in the financial statements under audit. For example, an amount that is material to the financial statements of one entity may not be material to the financial statements of another entity of a different size or nature. Also, what is material to the financial statements of a particular entity might change from one period to another.

.06 The auditor's consideration of materiality is a matter of professional judgment and is influenced by his perception of the needs of a reasonable person who will rely on the financial statements. The perceived needs of a reasonable person are recognized in the discussion of materiality in Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

.07 As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.<sup>5</sup>

## Planning the Audit

.08 The auditor should consider audit risk and materiality both in (a) planning the audit and designing auditing procedures and (b) evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with generally accepted accounting principles. The auditor should consider audit risk and materiality in the first circumstance to obtain sufficient competent evidential matter on which to properly evaluate the financial statements in the second circumstance.

## Considerations at the Financial Statements Level <sup>6</sup>

.09 The auditor should plan the audit so that audit risk will be limited to a low level that is, in his professional judgment, appropriate for issuing an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms.

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<sup>5</sup> The auditor's responsibility for illegal acts is discussed in section 317, *Illegal Acts by Clients*.

<sup>6</sup> See section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraphs 10—12, for a further discussion of the consideration of audit risk at the financial statement level.

.10 Section 311, *Planning and Supervision*, requires the auditor, in planning the audit, to take into consideration, among other matters, his preliminary judgment about materiality levels for audit purposes.<sup>7</sup> That judgment may or may not be quantified.

.11 According to section 311, the nature, timing, and extent of planning and thus of the considerations of audit risk and materiality vary with the size and complexity of the entity, the auditor's experience with the entity, and his knowledge of the entity's business. Certain entity-related factors also affect the nature, timing, and extent of auditing procedures with respect to specific account balances and classes of transactions and related assertions. (See paragraphs .17 through .26.)

.12 In planning the audit, the auditor should use his judgment as to the appropriately low level of audit risk and his preliminary judgment about materiality levels in a manner that can be expected to provide him, within the inherent limitations of the auditing process, with sufficient evidential matter to obtain reasonable assurance about whether the financial statements are free of material misstatement. Materiality levels include an overall level for each statement; however, because the statements are interrelated, and for reasons of efficiency, the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatements that could be considered material to any one of the financial statements. For example, if he believes that misstatements aggregating approximately \$100,000 would have a material effect on income but that such misstatements would have to aggregate approximately \$200,000 to materially affect financial position, it would not be appropriate for him to design auditing procedures that would be expected to detect misstatements only if they aggregate approximately \$200,000.

.13 The auditor plans the audit to obtain reasonable assurance of detecting misstatements that he believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. Although the auditor should be alert for misstatements that could be qualitatively material, it ordinarily is not practical to design procedures to detect them. Section 326, *Evidential Matter*, states that "an auditor typically works within economic limits; his opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost."

.14 In some situations, the auditor considers materiality for planning purposes before the financial statements to be audited are prepared. In other situations, his planning takes place after the financial statements under audit have been prepared, but he may be aware that they require significant modification. In both types of situations, the auditor's preliminary judgment about materiality might be based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods, as long as he gives recognition to the effects of major changes in the entity's circumstances (for example, a significant merger) and relevant changes in the economy as a whole or the industry in which the entity operates.

.15 Assuming, theoretically, that the auditor's judgment about materiality at the planning stage was based on the same information available to him at the evaluation stage, materiality for planning and evaluation purposes would be the same. However, it ordinarily is not feasible for the auditor, when

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<sup>7</sup> This section amends section 311, *Planning and Supervision*, paragraph .03e, by substituting the words "Preliminary judgment about materiality levels" in place of the words "Preliminary estimates of materiality levels." [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

planning an audit, to anticipate all of the circumstances that may ultimately influence his judgment about materiality in evaluating the audit findings at the completion of the audit. Thus, his preliminary judgment about materiality ordinarily will differ from his judgment about materiality used in evaluating the audit findings. If significantly lower materiality levels become appropriate in evaluating his audit findings, the auditor should reevaluate the sufficiency of the auditing procedures he has performed.

.16 In planning auditing procedures, the auditor should also consider the nature, cause (if known), and amount of misstatements that he is aware of from the audit of the prior period's financial statements.

### **Considerations at the Individual Account-Balance or Class-of-Transactions Level**

.17 The auditor recognizes that there is an inverse relationship between audit risk and materiality considerations. For example, the risk that a particular account balance or class of transactions and related assertions could be misstated by an extremely large amount might be very low, but the risk that it could be misstated by an extremely small amount might be very high. Holding other planning considerations equal, either a decrease in the level of audit risk that the auditor judges to be appropriate in an account balance or class of transactions or a decrease in the amount of misstatements in the balance or class that he believes could be material would require the auditor to do one or more of the following: (a) select a more effective auditing procedure, (b) perform auditing procedures closer to the balance-sheet date, or (c) increase the extent of a particular auditing procedure.

.18 In determining the nature, timing, and extent of auditing procedures to be applied to a specific account balance or class of transactions, the auditor should design procedures to obtain reasonable assurance of detecting misstatements that he believes, based on his preliminary judgment about materiality, could be material, when aggregated with misstatements in other balances or classes, to the financial statements taken as a whole. Auditors use various methods to design procedures to detect such misstatements. In some cases, auditors explicitly estimate, for planning purposes, the maximum amount of misstatements in the balance or class that, when combined with misstatements in other balances or classes, could exist without causing the financial statements to be materially misstated. In other cases, auditors relate their preliminary judgment about materiality to a specific account balance or class of transactions without explicitly estimating such misstatements.

.19 The auditor needs to consider audit risk at the individual account-balance or class-of-transactions level because such consideration directly assists him in determining the scope of auditing procedures for the balance or class and related assertions. The auditor should seek to restrict audit risk at the individual balance or class level in such a way that will enable him, at the completion of his examination, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk. Auditors use various approaches to accomplish that objective.

.20 At the account-balance or class-of-transactions level, audit risk consists of (a) the risk (consisting of inherent risk and control risk) that the balance or class and related assertions contain misstatements that could be material to the financial statements when aggregated with misstatements in other balance or classes and (b) the risk (detection risk) that the auditor will not detect such misstatements. The discussion that follows describes audit risk



in terms of three component risks.<sup>8</sup> The way the auditor considers these component risks and combines them involves professional judgment and depends on his audit approach.

- a. *Inherent risk* is the susceptibility of an assertion to a material misstatement, assuming that there are no related internal control structure policies or procedures. The risk of such misstatement is greater for some assertions and related balances or classes than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cash is more susceptible to theft than an inventory of coal. Accounts consisting of amounts derived from accounting estimates pose greater risks than do accounts consisting of relatively routine, factual data. External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. In addition to those factors that are peculiar to a specific assertion for an account balance or class of transactions, factors that relate to several or all of the balances or classes may influence the inherent risk related to an assertion for a specific balance or class. These latter factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures. (See section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraph .10.)
- b. *Control risk* is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure policies or procedures. That risk is a function of the effectiveness of the design and operation of internal control structure policies or procedures in achieving the entity's broad internal control structure objectives relevant to an audit of the entity's financial statements. Some control risk will always exist because of the inherent limitations of any internal control structure.
- c. *Detection risk* is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or class of transactions and partly because of other uncertainties that exist even if he were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards.

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<sup>8</sup> The formula in the appendix to section 350, *Audit Sampling*, describes audit risk in terms of four component risks. Detection risk is presented in terms of two components: the risk that analytical procedures and other relevant substantive tests would fail to detect misstatements equal to tolerable misstatement, and the allowable risk of incorrect acceptance for the substantive test of details.

.21 Inherent risk and control risk differ from detection risk in that they exist independently of the audit of financial statements, whereas detection risk relates to the auditor's procedures and can be changed at his discretion. Detection risk should bear an inverse relationship to inherent and control risk. The less the inherent and control risk the auditor believes exists, the greater the detection risk he can accept. Conversely, the greater the inherent and control risk the auditor believes exists, the less the detection risk he can accept. These components of audit risk may be assessed in quantitative terms such as percentages or in nonquantitative terms that range, for example, from a minimum to a maximum.

.22 When the auditor assesses inherent risk for an assertion related to an account balance or class of transactions, he evaluates numerous factors that involve professional judgment. In doing so, he considers not only factors peculiar to the related assertion, but also, other factors pervasive to the financial statements taken as a whole that may also influence inherent risk related to the assertion. If an auditor concludes that the effort required to assess inherent risk for an assertion would exceed the potential reduction in the extent of his auditing procedures derived from such an assessment, he should assess inherent risk as being at the maximum when designing auditing procedures.

.23 The auditor also uses professional judgment in assessing control risk for an assertion related to the account balance or class of transactions. The auditor's assessment of control risk is based on the sufficiency of evidential matter obtained to support the effectiveness of internal control structure policies or procedures in preventing or detecting misstatements in financial statement assertions. If the auditor believes control structure policies or procedures are unlikely to pertain to an assertion or are unlikely to be effective, or if he believes that evaluating their effectiveness would be inefficient, he would assess control risk for that assertion at the maximum.

.24 The auditor might make separate or combined assessments of inherent risk and control risk. If he considers inherent risk or control risk, separately or in combination, to be less than the maximum, he should have an appropriate basis for his assessments. This basis may be obtained, for example, through the use of questionnaires, checklists, instructions, or similar generalized materials and, in the case of control risk, his understanding of the internal control structure and his performance of suitable tests of controls. However, professional judgment is required in interpreting, adapting, or expanding such generalized material as appropriate in the circumstances.

.25 The detection risk that the auditor can accept in the design of auditing procedures is based on the level to which he seeks to restrict audit risk related to the account balance or class of transactions and on his assessment of inherent and control risks. As the auditor's assessment of inherent risk and control risk decreases, the detection risk that he can accept increases. It is not appropriate, however, for an auditor to rely completely on his assessments of inherent risk and control risk to the exclusion of performing substantive tests of account balances and classes of transactions where misstatements could exist that might be material when aggregated with misstatements in other balances or classes.

.26 An audit of financial statements is a cumulative process; as the auditor performs planned auditing procedures, the evidence he obtains may cause him to modify the nature, timing, and extent of other planned procedures. Information may come to the auditor's attention as result of performing auditing procedures or from other sources during the audit that differs significantly from the information on which his audit plan was based. For

example, the extent of misstatements he detects may alter his judgment about the levels of inherent and control risks, and other information he obtains about the financial statements may alter his preliminary judgment about materiality. In such cases, he may need to reevaluate the auditing procedures he plans to apply, based on his revised consideration of audit risk and materiality for all or certain of the account balances or classes of transactions and related assertions.

## Evaluating Audit Findings

.27 In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, the auditor should aggregate misstatements that the entity has not corrected in a way that enables him to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole. Qualitative considerations also influence an auditor in reaching a conclusion as to whether misstatements are material.

.28 The aggregation of misstatements should include the auditor's best estimate of the total misstatements in the account balances or classes of transactions that he has examined (hereafter referred to as likely misstatement<sup>9</sup>), not just the amount of misstatements he specifically identifies (hereafter referred to as known misstatement).<sup>10</sup> When the auditor tests an account balance or class of transactions and related assertions by an analytical procedure, he ordinarily would not specifically identify misstatements but would only obtain an indication of whether misstatement might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that misstatement might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him to estimate the likely misstatement in the balance or class. When an auditor uses audit sampling to test an assertion for an account balance or class of transactions, he projects the amount of known misstatements he identified in his sample to the items in the balance or class from which his sample was selected. That projected misstatement, along with the results of other substantive tests, contributes to the auditor's assessment of likely misstatement in the balance or class.

.29 The risk of material misstatement of the financial statements is generally greater when account balances and classes of transactions include accounting estimates rather than essentially factual data because of the inherent subjectivity in estimating future events. Estimates, such as those for inventory obsolescence, uncollectable receivables, and warranty obligations, are subject not only to the unpredictability of future events but also to misstatements that may arise from using inadequate or inappropriate data or misapplying appropriate data. Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However,

<sup>9</sup> See section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraphs 22–25, for a further discussion of the auditor's consideration of differences between the accounting records and the underlying facts and circumstances. This section provides specific guidance on the auditor's consideration of an audit adjustment that is, or may be, an irregularity.

<sup>10</sup> If the auditor were to examine all of the items in a balance or class, the likely misstatement applicable to recorded transactions in the balance or class would be the amount of known misstatements specifically identified.

if the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements. The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole.

**.30** In prior periods, likely misstatements may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those misstatements might also affect the current period's financial statements.<sup>11</sup> If the auditor believes that there is an unacceptably high risk that the current period's financial statements may be materially misstated when those prior-period likely misstatements that affect the current period's financial statements are considered along with likely misstatements arising in the current period, he should include in aggregate likely misstatement the effect on the current period's financial statements of those prior-period likely misstatements.

**.31** If the auditor concludes, based on his accumulation of sufficient evidential matter, that the aggregation of likely misstatements causes the financial statements to be materially misstated, he should request management to eliminate the material misstatement. If the material misstatement is not eliminated, he should issue a qualified or adverse opinion on the financial statements. Material misstatements may be eliminated by, for example, application of appropriate accounting principles, other adjustments in amounts, or the addition of appropriate disclosure of inadequately disclosed matters. Even though the aggregate effect of likely misstatements on the financial statements may be immaterial, the auditor should recognize that an accumulation of immaterial misstatements in the balance sheet could contribute to material misstatements of future financial statements.

**.32** If the auditor concludes that the aggregation of likely misstatements does not cause the financial statements to be materially misstated, he should recognize that they could still be materially misstated due to further misstatement remaining undetected. As aggregate likely misstatement increases, the risk that the financial statements may be materially misstated also increases. Auditors generally reduce this risk of material misstatement in planning the audit by restricting the extent of detection risk they are willing to accept for an assertion related to an account balance or class of transactions. Auditors can also reduce this risk of material misstatement by modifying the nature, timing, and extent of planned auditing procedures on a continuous basis in performing the audit. (See paragraph .26.) Nevertheless, if the auditor believes that such risk is unacceptably high, he should perform additional auditing procedures or satisfy himself that the entity has adjusted the financial statements to reduce the risk of material misstatement to an acceptable level.

## Effective Date

**.33** This section is effective for audits of financial statements for periods beginning after June 30, 1984.

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<sup>11</sup> The measurement of the effect, if any, on the current period's financial statements of misstatements uncorrected in prior periods involves accounting considerations and is therefore not addressed in this section.

## AU Section 313

### ***Substantive Tests Prior to the Balance-Sheet Date***

*(Supersedes Statement on Auditing Standards*

*No. 1, AICPA, Professional Standards,*

*vol. 1, AU sec. 310.05—.09.)<sup>\*</sup>*

**Source: SAS No. 45.**

**Effective for periods ended after September 30, 1983, unless otherwise indicated.**

.01 This section provides guidance for audits of financial statements concerning—

- a. Factors to be considered before applying principal substantive tests to the details of particular asset or liability accounts as of a date (*interim date*) that is prior to the balance-sheet date.
- b. Auditing procedures to provide a reasonable basis for extending from an interim date to the balance-sheet date (*remaining period*) the audit conclusions from such principal substantive tests.
- c. Coordinating the timing of auditing procedures.

Guidance concerning the timing of tests of controls is provided in section 319.55.

.02 Audit testing at interim dates may permit early consideration of significant matters affecting the year-end financial statements (for example, related party transactions, changed conditions, recent accounting pronouncements, and financial statement items likely to require adjustment). In addition, much of the audit planning, including obtaining an understanding of the internal control structure, assessing control risk and the application of substantive tests to transactions can be conducted prior to the balance-sheet date.<sup>1</sup>

.03 Applying principal substantive tests to the details of an asset or liability account as of an interim date rather than as of the balance-sheet date potentially increases the risk that misstatements that may exist at the balance-sheet date will not be detected by the auditor. The potential for such increased audit risk tends to become greater as the remaining period is lengthened. This potential incremental audit risk can be controlled, however,

<sup>\*</sup> Editor's note deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

<sup>1</sup> Substantive tests such as the following can be applied to transactions through any selected date(s) prior to the balance-sheet date and completed as part of the year-end procedures: (1) tests of details of the additions to and reductions of accounts such as property, investments, and debt and equity capital; (2) tests of details of transactions affecting income and expense accounts; (3) tests of accounts that are not to be audited by testing the details of items composing the balance (for example, warranty reserves, clearing accounts, certain deferred charges); and (4) analytical procedures applied to income and expense accounts.

if the substantive tests to cover the remaining period can be designed in a way that will provide a reasonable basis for extending to the balance-sheet date the audit conclusions from the tests of details at the interim date.

### **Factors to Be Considered Before Applying Principal Substantive Tests to the Details of Balance-Sheet Accounts at Interim Dates**

**.04** Before applying principal substantive tests to the details of asset or liability accounts at an interim date, the auditor should assess the difficulty in controlling the incremental audit risk. Paragraphs .05 through .07 discuss considerations that affect that assessment. In addition, the auditor should consider the cost of the substantive tests that are necessary to cover the remaining period in a way that will provide the appropriate audit assurance at the balance-sheet date. Applying principal substantive tests to the details of asset and liability accounts at an interim date may not be cost-effective if substantive tests to cover the remaining period cannot be restricted due to the assessed level of control risk.

**.05** Assessing control risk at below the maximum is not required in order to have a reasonable basis for extending audit conclusions from an interim date to the balance-sheet date; however, if the auditor assesses control risk at the maximum during the remaining period, he should consider whether the effectiveness of certain of the substantive tests to cover that period will be impaired. For example, effective internal control structure policies and procedures may be lacking over the internal documents that provide indications of transactions that have been executed. Substantive tests that are based on such documents and relate to the completeness assertion for the remaining period may be ineffective because the documents may be incomplete. Likewise, substantive tests covering the remaining period that relate to the existence assertion at the balance-sheet date may be ineffective if effective internal control structure policies and procedures over the custody and physical movement of assets are not present. In both of the above examples, if the auditor concludes that the effectiveness of such substantive tests would be impaired, additional assurance should be sought or the accounts should be examined as of the balance-sheet date.

**.06** The auditor should consider whether there are rapidly changing business conditions or circumstances that might predispose management to misstate financial statements in the remaining period.<sup>2</sup> If such conditions or circumstances are present, the auditor might conclude that the substantive tests to cover the remaining period would not be effective in controlling the incremental audit risk associated with them. In those situations, the asset and liability accounts affected should ordinarily be examined as of the balance-sheet date.

**.07** The auditor should consider whether the year-end balances of the particular asset or liability accounts that might be selected for interim examination are reasonably predictable with respect to amount, relative significance, and composition. He should also consider whether the entity's proposed procedures for analyzing and adjusting such accounts at interim dates and for establishing proper accounting cutoffs are appropriate. In addition, the auditor should consider whether the accounting system will provide information concerning the balances at the balance-sheet date and the transactions in the remaining period that is sufficient to permit investigation

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<sup>2</sup> See paragraphs .10—.12 of section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.

of (a) significant unusual transactions or entries (including those at or near year-end); (b) other causes of significant fluctuations, or expected fluctuations that did not occur; and (c) changes in the composition of the account balances. If the auditor concludes that evidential matter related to the above would not be sufficient for purposes of controlling audit risk, the account should be examined as of the balance-sheet date.

## Extending Audit Conclusions to the Balance-Sheet Date

.08 Substantive tests should be designed to cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of an interim date, and any audit assurance provided from the assessed level of control risk, achieve the audit objectives at the balance-sheet date. Such tests ordinarily should include (a) comparison of information concerning the balance at the balance-sheet date with the comparable information at the interim date to identify amounts that appear unusual and investigation of any such amounts and (b) other analytical procedures or substantive tests of details, or a combination of both, to provide a reasonable basis for extending to the balance-sheet date the audit conclusions relative to the assertions tested directly or indirectly at the interim date.<sup>3</sup>

.09 If misstatements are detected in account balances at interim dates, the auditor may be required to modify the planned nature, timing, or extent of the substantive tests covering the remaining period that relate to such accounts or to reperform certain auditing procedures at the balance-sheet date. The assessment of possible misstatement as of the balance-sheet date should be based on the auditor's judgment of the state of the particular account(s) as of that date, after considering (a) the possible implications of the nature and cause of the misstatements detected at the interim date, (b) the possible relationship to other phases of the audit, (c) the corrections subsequently recorded by the entity, and (d) the results of auditing procedures covering the remaining period (including those that are responsive to the particular possibilities for misstatement). For example, the auditor might conclude that the estimate of unrecorded credit memos at an interim date is representative of such misstatements at the balance-sheet date, based on substantive tests covering the remaining period. On the other hand, the assessment of the possible effects at the balance-sheet date of other types of cutoff misstatements at an interim date might be based on the results of reperforming substantive tests of the cutoff.

## Coordinating the Timing of Auditing Procedures

.10 The timing of auditing procedures also involves consideration of whether related auditing procedures are properly coordinated. This includes, for example—

- a. Coordinating the auditing procedures applied to related party transactions and balances.<sup>4</sup>
- b. Coordinating the testing of interrelated accounts and accounting cutoffs.

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<sup>3</sup> Factors to be considered in determining the relative mix of tests of details and analytical procedures include (1) the nature of the transactions and balances in relation to the assertions involved, (2) the availability of historical data or other criteria for use in analytical procedures, and (3) the availability of records required for effective tests of details and the nature of the tests to which they are susceptible.

<sup>4</sup> See section 334, *Related Parties*.

- c. Maintaining temporary audit control over assets that are readily negotiable and simultaneously testing such assets and cash on hand and in banks, bank loans, and other related items.

Decisions about coordinating related auditing procedures should be made in the light of the assessed level of control risk and of the particular auditing procedures that could be applied, either for the remaining period or at year-end, or both.

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**AU Section 315*****Communications Between  
Predecessor and  
Successor Auditors***

(Supersedes section 543.18)

Source: SAS No. 7.

See section 9315 for interpretations of this section.

Effective November 30, 1975, unless otherwise indicated.\*

.01 The purpose of this section is to provide guidance on communications between predecessor and successor auditors when a change of auditors has taken place or is in process. The term "predecessor auditor" refers to an auditor who has resigned or who has been notified that his services have been terminated. The term "successor auditor" refers to an auditor who has accepted an engagement or an auditor who has been invited to make a proposal for an engagement. This section applies whenever an independent auditor has been retained, or is to be retained, to audit the financial statements in accordance with generally accepted auditing standards.

.02 The initiative in communicating rests with the successor auditor. The communication may be either written or oral. Both the predecessor and successor auditors should hold in confidence information obtained from each other. This obligation applies whether or not the successor accepts the engagement.

.03 Prior to acceptance of the engagement, the successor auditor should attempt certain communications that are described in paragraphs .04 through .07. Other communications between the successor and the predecessor, described in paragraphs .08 and .09 are advisable. However, their timing is more flexible. The successor may attempt these other communications either prior to acceptance of the engagement or subsequent thereto.

**Communications Before Successor Accepts Engagement**

.04 Inquiry of the predecessor auditor is a necessary procedure because the predecessor may be able to provide the successor with information that will assist him in determining whether to accept the engagement. The successor should bear in mind that, among other things, the predecessor and the client may have disagreed about accounting principles, auditing procedures, or similarly significant matters.

.05 The successor auditor should explain to his prospective client the need to make an inquiry of the predecessor and should request permission to do so.

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\* See paragraph .12.

Except as permitted by the Rules of the Code of Professional Conduct, an auditor is precluded from disclosing confidential information obtained in the course of an audit engagement unless the client specifically consents. Thus, the successor auditor should ask the prospective client to authorize the predecessor to respond fully to the successor's inquiries. If a prospective client refuses to permit the predecessor to respond or limits the response, the successor auditor should inquire as to the reasons and consider the implications of that refusal in deciding whether to accept the engagement.

**.06** The successor auditor should make specific and reasonable inquiries of the predecessor regarding matters that the successor believes will assist him in determining whether to accept the engagement. His inquiries should include specific questions regarding, among other things, facts that might bear on the integrity of management; on disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters; and on the predecessor's understanding as to the reasons for the change of auditors.

**.07** The predecessor auditor should respond promptly and fully, on the basis of facts known to him, to the successor's reasonable inquiries. However, should he decide, due to unusual circumstances such as impending litigation, not to respond fully to the inquiries, he should indicate that his response is limited. If the successor auditor receives a limited response, he should consider its implications in deciding whether to accept the engagement.

## Other Communications

**.08** When one auditor succeeds another, the successor auditor must obtain sufficient competent evidential matter to afford a reasonable basis for expressing his opinion on the financial statements he has been engaged to audit as well as for evaluating the consistency of the application of accounting principles in that year as compared with the preceding year. This may be done by applying appropriate auditing procedures to the account balances at the beginning of the period under audit and in some cases to transactions in prior periods. The successor auditor's audit may be facilitated by (a) making specific inquiries of the predecessor regarding matters that the successor believes may affect the conduct of his audit, such as audit areas that have required an inordinate amount of time or audit problems that arose from the condition of the accounting system and records and (b) reviewing the predecessor auditor's working papers. In reporting on his audit, however, the successor auditor should not make reference to the report or work of the predecessor auditor as the basis, in part, for his own opinion.

**.09** The successor auditor should request the client to authorize the predecessor to allow a review of the predecessor's working papers. It is customary in such circumstances for the predecessor auditor to make himself available to the successor auditor for consultation and to make available for review certain of his working papers. The predecessor and successor auditors should agree on those working papers that are to be made available for review and those that may be copied. Ordinarily, the predecessor should permit the successor to review working papers relating to matters of continuing accounting significance, such as the working paper analysis of balance sheet accounts, both current and noncurrent, and those relating to contingencies. Valid business reasons, however, may lead the predecessor auditor to decide not to allow a review of his working papers. Further, when more than one successor auditor is considering acceptance of an engagement, the predecessor auditor should not be expected to make himself or his working papers available until the successor has accepted the engagement.

## Financial Statements Reported on by Predecessor

.10 If during his audit the successor auditor becomes aware of information that leads him to believe that financial statements reported on by the predecessor auditor may require revision, he should request his client to arrange a meeting among the three parties to discuss this information and attempt to resolve the matter.<sup>1</sup> If the client refuses or if the successor is not satisfied with the result, the successor auditor may be well advised to consult with his attorney in determining an appropriate course of further action.

[.11] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977, as superseded by section 508.]

## Effective Date

.12 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this Statement provides for practices that may differ in certain respects from practices heretofore considered acceptable it will be effective with respect to changes in auditors in which the successor auditor's consideration of acceptance of an engagement begins after November 30, 1975.

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[The next page is 239.]

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<sup>1</sup> See sections 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, and 711.11—.12, *Filings Under Federal Securities Statutes*, for guidance on action to be taken by the predecessor auditor. [Reference changed by issuance of Statement on Auditing Standards No. 37.]

**AU Section 9315*****Communications Between Predecessor and Successor Auditors: Auditing Interpretations of Section 315*****1. Determining the Predecessor Auditor**

**.01. Question**—Section 315, *Communications Between Predecessor and Successor Auditors*, requires that before accepting an audit engagement an auditor attempt certain communications with the predecessor auditor. Occasionally, a successor auditor is replaced before completing an audit engagement and issuing a report. In such cases, is another auditor who is considering accepting the engagement required to communicate with the original auditor, the successor auditor who is being replaced, or both?

**.02 Interpretation**—Both. The situation described is unusual and the auditor who is considering accepting the engagement needs complete information to help him decide whether to accept it. To obtain complete information, he should attempt to communicate with both the original auditor and the one he is replacing. That is, both auditors are considered to be predecessor auditors.

**.03** In such circumstances, the second successor auditor should make specific and reasonable inquiries of each predecessor auditor regarding matters that the successor believes will assist him in determining whether to accept the engagement. Inquiring of only one of the predecessor auditors would not result in a full response because the circumstances surrounding each change in auditors may be different and the predecessor auditors, having served at different times and for different lengths of time, may have different knowledge about the potential client. In addition, inquiring of each predecessor is relevant since both auditor changes occurred during the period since the issuance of the most recent audit report.

**.04** For a publicly held client, the successor might supplement direct inquiries by reviewing any SEC forms 8-K filed regarding auditor changes and any related letters filed with the SEC by the predecessor auditors.

**.05** Each predecessor auditor should respond promptly and fully, on the basis of facts known to him, to the successor's reasonable inquiries. A predecessor auditor would not be responding fully when his response is evasive or omits significant information. If either predecessor auditor, due to unusual circumstances, limits his response, he should inform the successor auditor of the limitation and the successor should consider the implications of such a limitation in light of information of which he is aware.

[Issue Date: May, 1985.]

**2. Restating Financial Statements Reported on by a Predecessor Auditor**

**.06 Question**—Occasionally, a successor auditor becomes aware of information that leads him to believe that prior period financial statements reported on by a predecessor auditor require restatement. Is it necessary in

such a situation for the successor auditor to discuss the information with the predecessor auditor before referring to the restatement adjustments made to the previously issued financial statements?

**.07 Answer—**Yes. The successor auditor should discuss with the predecessor auditor information that he believes requires restatement of the financial statements because such information may have been considered by the predecessor auditor. The successor auditor should communicate to the predecessor any information that the predecessor auditor may need to consider in accordance with section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, which sets out the procedures that an auditor should follow when he subsequently discovers facts which may have affected the audited financial statements previously reported on.

[Issue Date: September, 1986.]

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[The next page is 245.]

## AU Section 316

# ***The Auditor's Responsibility to Detect and Report Errors and Irregularities***

(Supersedes section 327)

Source: SAS No. 53.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance on the independent auditor's responsibility for the detection of errors and irregularities in an audit of financial statements in accordance with generally accepted auditing standards. It describes factors that influence the auditor's ability to detect errors and irregularities and explains how the exercise of due care should give appropriate consideration to the possibility of errors or irregularities. It also provides guidance on the auditor's responsibility to communicate detected matters both within and outside the entity whose financial statements are under audit.

### **Definition of Errors and Irregularities**

.02 The term *errors* refers to *unintentional* misstatements or omissions of amounts or disclosures in financial statements. Errors may involve—

- Mistakes in gathering or processing accounting data from which financial statements are prepared.
- Incorrect accounting estimates arising from oversight or misinterpretation of facts.
- Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.<sup>1</sup>

.03 The term *irregularities* refers to *intentional* misstatements or omissions of amounts or disclosures in financial statements. Irregularities include fraudulent financial reporting undertaken to render financial statements misleading, sometimes called *management fraud*, and misappropriation of assets, sometimes called *defalcations*. Irregularities may involve acts such as the following:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- Misrepresentation or intentional omission of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

.04 The primary factor that distinguishes errors from irregularities is whether the underlying cause of a misstatement in financial statements is

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<sup>1</sup> Errors do not include the effect of accounting processes employed for convenience, such as maintaining accounting records on the cash basis or the tax basis and periodically adjusting those records to prepare financial statements in conformity with generally accepted accounting principles.

intentional or unintentional. Intent, however, is often difficult to determine, particularly in matters involving accounting estimates or the application of accounting principles. For example, an unreasonable accounting estimate may result from unintentional bias or may be an intentional attempt to misstate the financial statements.

## **The Auditor's Responsibility to Detect Errors and Irregularities**

.05 The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.<sup>2,3</sup>

.06 The auditor's assessment of the risk of material misstatement of the financial statements requires the auditor to understand the characteristics of errors and irregularities that are discussed in paragraph .34 and the complex interaction of those characteristics. Based on that understanding, the auditor designs and performs appropriate audit procedures and evaluates the results.

.07 Because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is the auditor trained to do so. Also, audit procedures that are effective for detecting a misstatement that is unintentional may be ineffective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

.08 The auditor should exercise (a) due care in planning, performing, and evaluating the results of audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected. Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement exists in the financial statements does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.

## **Consideration of the Possibility of Material Misstatements in Audit Planning**

.09 In developing an audit plan, the auditor should consider factors influencing audit risk that relate to several or all account balances and obtain an understanding of the internal control structure.<sup>4</sup> These matters often have effects pervasive to the financial statements taken as a whole and also

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<sup>2</sup> The concept of reasonable assurance is recognized in the third standard of fieldwork, "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination" and is discussed in section 326, *Evidential Matter*, and section 350, *Audit Sampling*.

<sup>3</sup> The auditor's responsibility for detecting misstatements resulting from illegal acts, as defined in section 317, *Illegal Acts By Clients*, having a direct and material effect on the determination of financial statement amounts is the same as that for other errors and irregularities.

<sup>4</sup> See section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*.

influence the auditor's consideration of risk at the account balance or class-of-transactions level.

### **Consideration of Audit Risk at the Financial Statement Level**

.10 An assessment of the risk of material misstatements should be made during planning. The auditor's understanding of the internal control structure should either heighten or mitigate the auditor's concern about the risk of material misstatements. The factors considered in assessing risk should be considered in combination to make an overall judgment; the presence of some factors in isolation would not necessarily indicate increased risk. Factors such as those listed below may be considered.

#### *Management Characteristics*

- Management operating and financing decisions are dominated by a single person.
- Management's attitude toward financial reporting is unduly aggressive.
- Management (particularly senior accounting personnel) turnover is high.
- Management places undue emphasis on meeting earnings projections.
- Management's reputation in the business community is poor.

#### *Operating and Industry Characteristics*

- Profitability of entity relative to its industry is inadequate or inconsistent.
- Sensitivity of operating results to economic factors (inflation, interest rates, unemployment, etc.) is high.
- Rate of change in entity's industry is rapid.
- Direction of change in entity's industry is declining with many business failures.
- Organization is decentralized without adequate monitoring.
- Internal or external matters that raise substantial doubt about the entity's ability to continue as a going concern are present. (See section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.)

#### *Engagement Characteristics*

- Many contentious or difficult accounting issues are present.
- Significant difficult-to-audit transactions or balances are present.
- Significant and unusual related party transactions not in the ordinary course of business are present.
- Nature, cause (if known), or the amount of known and likely misstatements detected in the audit of prior period's financial statements is significant.
- It is a new client with no prior audit history or sufficient information is not available from the predecessor auditor.

.11 The size, complexity, and ownership characteristics of the entity have a significant influence on the risk factors considered to be important. For example, for a large entity, the auditor would ordinarily give consideration to factors that constrain improper conduct by senior management, such as the



effectiveness of the board of directors, the audit committee or others with equivalent authority and responsibility,<sup>5</sup> and the internal audit function. Consideration would also be given to the measures taken to enforce a formal code of conduct and the effectiveness of the budgeting or responsibility reporting system. For a small entity some of these matters might be considered inapplicable or unimportant, particularly if the auditor's past experience with the entity has been that effective owner-manager or trustee involvement creates a good control environment.

.12 The auditor should assess the risk of management misrepresentation by reviewing information obtained about risk factors and the internal control structure. Matters such as the following may be considered:

- Are there known circumstances that may indicate a management predisposition to distort financial statements, such as frequent disputes about aggressive application of accounting principles that increase earnings, evasive responses to audit inquiries, or excessive emphasis on meeting quantified targets that must be achieved to receive a substantial portion of management compensation?
- Are there indications that management has failed to establish policies and procedures that provide reasonable assurance of reliable accounting estimates, such as personnel who develop estimates appearing to lack necessary knowledge and experience, supervisors of these personnel appearing careless or inexperienced, or there is a history of unreliable or unreasonable estimates?
- Are there conditions that indicate lack of control of activities, such as constant crisis conditions in operating or accounting areas, disorganized work areas, frequent or excessive back orders, shortages, delays, or lack of documentation for major transactions?
- Are there indications of a lack of control over computer processing, such as a lack of controls over access to applications that initiate or control the movement of assets (for example, a demand deposit application in a bank), high levels of processing errors, or unusual delays in providing processing results and reports?
- Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets, such as not investigating employees in key positions before hiring, or allowing unauthorized personnel to have ready access to data or assets?

.13 The auditor should consider the effect of the matters described in paragraphs .10 to .12 on the overall audit strategy and the expected conduct and scope of the audit.

### **The Auditor's Response to Risk at the Financial Statement Level**

.14 The auditor's overall judgment about the level of risk in an engagement may affect engagement staffing, extent of supervision, overall strategy for expected conduct and scope of audit, and degree of professional skepticism applied. Thus, the auditor's assessment of risk may affect audit planning in one or more of the following ways. The experience and training of personnel assigned significant engagement responsibilities should be commensurate with

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<sup>5</sup> For entities that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

the auditor's assessment of the level of risk for the engagement. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement. Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of the balance sheet date, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence. Higher risk will also ordinarily cause the auditor to exercise a heightened degree of professional skepticism in conducting the audit (see paragraphs .16 to .21).

### **The Auditor's Consideration of Audit Risk at the Balance or Class Level**

.15 The following matters are examples of factors that may influence the auditor's consideration of risk of material misstatement related to particular assertions at the balance or class level:<sup>6</sup>

- Effect of risk factors identified at the financial statement or engagement level on the particular account balance or transaction class
- Complexity and contentiousness of accounting issues affecting balance or class
- Frequency or significance of difficult-to-audit transactions affecting balance or class
- Nature, cause, and amount of known and likely misstatements detected in the balance or class in the prior audit
- Susceptibility of related assets to misappropriation
- Competence and experience of personnel assigned to processing data that affect the balance or class
- Extent of judgment involved in determining the total balance or class
- Size and volume of individual items constituting the balance or class
- Complexity of calculations affecting the balance or class

### **Professional Skepticism**

.16 An audit of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of professional skepticism. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, the auditor recognizes that conditions observed and evidential matter obtained, including information from prior audits, need to be objectively evaluated to determine whether the financial statements are free of material misstatement.

.17 Management integrity is important because management can direct subordinates to record transactions or conceal information in a manner that can materially misstate financial statements. When approaching difficult-to-substantiate assertions, the auditor should recognize the increased importance of his consideration of factors that bear on management integrity. A presumption of management dishonesty, however, would be contrary to the accumulated experience of auditors. Moreover, if dishonesty were presumed, the auditor would potentially need to question the genuineness of all records and documents obtained from the client and would require conclusive rather than

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<sup>6</sup> Additional factors relating to risk assessment are found in section 312, *Audit Risk and Materiality in Conducting an Audit*.

persuasive evidence to corroborate all management representations. An audit conducted on these terms would be unreasonably costly and impractical.

### **Professional Skepticism in Audit Planning**

.18 Whenever the auditor has reached a conclusion that there is significant risk of material misstatement of the financial statements, the auditor reacts in one or more ways. The auditor should consider this assessment in determining the nature, timing, or extent of procedures, assigning staff, or requiring appropriate levels of supervision. The auditor may identify specific transactions involving senior management and confirm the details with appropriate external parties and review in detail all material accounting entries prepared or approved by senior management.

.19 The auditor should consider whether accounting policies are acceptable in the circumstances. However, when the auditor has reached a conclusion that there is significant risk of intentional distortion of financial statements, the auditor should recognize that management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation, and capitalization versus expensing, may be misused. Increased risk of intentional distortion of the financial statements should cause greater concern about whether accounting principles that are otherwise generally accepted are being used in inappropriate circumstances to create a distortion of earnings. For example, management might use the percentage of completion method in circumstances that do not justify its use to misstate operating results.

.20 When evaluation at the financial statement level indicates significant risk, the auditor requires more or different evidence to support material transactions than would be the case in the absence of such risk. For example, the auditor may perform additional procedures to determine that sales are properly recorded, giving consideration to the possibility that the buyer has a right to return the product. Transactions that are both large and unusual, particularly at year-end, should be selected for testing.

### **Professional Skepticism in Performance of the Audit**

.21 In performing procedures and gathering evidential matter, the auditor continually maintains an attitude of professional skepticism. The performance of auditing procedures during the audit may result in the detection of conditions or circumstances that should cause the auditor to consider whether material misstatements exist. If a condition or circumstance differs adversely from the auditor's expectation, the auditor needs to consider the reason for such a difference. Examples of such conditions or circumstances are as follows:

- Analytical procedures disclose significant differences from expectations.
- Significant unreconciled differences between reconciliations of a control account and subsidiary records or between a physical count and a related account are not appropriately investigated and corrected on a timely basis.
- Confirmation requests disclose significant differences or yield fewer responses than expected.
- Transactions selected for testing are not supported by proper documentation or are not appropriately authorized.
- Supporting records or files that should be readily available are not promptly produced when requested.

- Audit tests detect errors that apparently were known to client personnel, but were not voluntarily disclosed to the auditor.

When such conditions or circumstances exist, the planned scope of audit procedures should be reconsidered. As the number of differences from expectations or the frequency with which the auditor is unable to obtain satisfactory explanations increases, the auditor should consider whether the assessment of the risk of material misstatement of the financial statements made in the planning stage of the engagement is still appropriate.

## Evaluation of Audit Test Results

**.22** The auditor should evaluate the significance of differences between the accounting records and the underlying facts and circumstances detected by the application of auditing procedures. The auditor should consider both the quantitative and qualitative aspects of these matters and whether they are indicative of an error or an irregularity. Often a particular matter considered in isolation cannot be identified as an error or irregularity; nevertheless, this evaluation is important. Because irregularities are intentional, they have implications beyond their direct monetary effect and the auditor needs to consider the implications for other aspects of the audit.

**.23** The auditor's objective is to reach a conclusion on whether the financial statements, taken as a whole, are materially misstated. The auditor should accumulate potential audit adjustments during the audit and summarize and evaluate the combined effect. In this regard, the auditor may designate an amount below which potential audit adjustments need not be accumulated. This amount would be set so that any such adjustments, either individually or when aggregated with other adjustments, would not be material to the financial statements.

**.24** If the auditor has determined that an audit adjustment is, or may be, an irregularity, but has also determined that the effect on the financial statements could not be material, the auditor should—

- a. Refer the matter to an appropriate level of management that is at least one level above those involved.
- b. Be satisfied that, in view of the organizational position of the likely perpetrator, the irregularity has no implications for other aspects of the audit or that those implications have been adequately considered.

For example, irregularities involving misappropriation of cash from a small imprest fund would normally be of little significance because both the manner of operating the fund and its size would tend to establish a limit on the amount of loss and the custodianship of such a fund is normally entrusted to a relatively low-level employee.

**.25** If the auditor has determined that an audit adjustment is, or may be, an irregularity and has either determined that the effect could be material or has been unable to evaluate potential materiality, the auditor should—

- a. Consider the implications for other aspects of the audit.
- b. Discuss the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved.
- c. Attempt to obtain sufficient competent evidential matter to determine whether, in fact, material irregularities exist and, if so, their effect.

- d. If appropriate, suggest that the client consult with legal counsel on matters concerning questions of law.

## The Effect of Irregularities on the Audit Report

.26 If the auditor has concluded that the financial statements are materially affected by an irregularity, the auditor should insist that the financial statements be revised and, if they are not, express a qualified or an adverse opinion on the financial statements, disclosing all substantive reasons for his opinion.

.27 If the auditor is precluded from applying necessary procedures, or if, after the application of extended procedures, the auditor is unable to conclude whether possible irregularities may materially affect the financial statements, the auditor should—

- a. Disclaim or qualify an opinion on the financial statements.
- b. Communicate his findings to the audit committee or the board of directors.

If the client refuses to accept the auditor's report as modified for the circumstances described above, the auditor should withdraw from the engagement and communicate the reasons for withdrawal to the audit committee or board of directors. Whether the auditor concludes that withdrawal from the engagement is appropriate in other circumstances depends on the diligence and cooperation of senior management and the board of directors in investigating the circumstances and taking appropriate remedial action. For example, if the auditor is precluded by the client from obtaining reasonably available evidential matter, withdrawal ordinarily would be appropriate. However, because of the variety of circumstances that may arise, it is not possible to describe all those circumstances when withdrawal would be appropriate.

## Communications Concerning Errors or Irregularities

.28 For the audit committee<sup>7</sup> to make the informed judgments necessary to fulfill its responsibility for the oversight of financial reporting, the auditor should assure himself that the audit committee is adequately informed about any irregularities of which the auditor becomes aware during the audit unless those irregularities are clearly inconsequential.<sup>8</sup> For example, a minor defalcation by an employee at a low level in the organization might be considered inconsequential. However, irregularities involving senior management of which the auditor becomes aware should be reported directly to the audit committee. Irregularities that are individually immaterial may be reported to the audit committee on an aggregate basis, and the auditor may reach an understanding with the audit committee on the nature and amount of reportable irregularities.

.29 Disclosure of irregularities to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and would be precluded by the auditor's ethical or legal obligation of confidentiality unless the matter affects his opinion on the financial statements. The auditor should recognize, however,

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<sup>7</sup> See footnote 5.

<sup>8</sup> The auditor's responsibility to communicate errors within certain entities whose financial statements are under audit is described in section 380, *Communication With Audit Committees*.

that in the following circumstances a duty to disclose outside the client may exist:

- a. When the entity reports an auditor change under the appropriate securities law on Form 8-K<sup>9</sup>
- b. To a successor auditor when the successor makes inquiries in accordance with section 315, *Communications Between Predecessor and Successor Auditors*<sup>10</sup>
- c. In response to a subpoena
- d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing irregularities with parties outside the client.

## Responsibilities in Other Circumstances

.30 This section describes the auditor's responsibilities to detect and report errors and irregularities in an audit of a complete set of financial statements made in accordance with generally accepted auditing standards. In other engagements, the auditor's responsibilities may be more extensive or more restricted, depending on the terms of the engagement.

.31 The auditor may accept an engagement that necessitates a more extensive responsibility to detect or report irregularities. For example, in an audit in accordance with *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, 1981 Revision*, issued by the U.S. General Accounting Office, the auditor should be aware that such standards go beyond generally accepted auditing standards as they relate to notification when the audit indicates that irregularities may exist. These standards require the auditor not only to promptly report instances of irregularities to the audited entity's management, but also to report the matter to the funding agency or other specified agency.

.32 When an examination does not encompass a complete set of financial statements or a complete individual financial statement, or when the scope is less extensive than an audit in accordance with generally accepted auditing standards, the auditor's ability to detect material misstatements may be considerably reduced. For example, in an engagement to report on specified elements, accounts, or items of financial statements, the auditor's procedures focus on the specific element, account, or item and the special purpose of the engagement. In these circumstances, the auditor's assessment of risk at the financial statement level and other aspects of the examination that relate to the entity and its financial statements taken as a whole is necessarily more restricted.

## Effective Date

.33 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

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<sup>9</sup> Disclosure to the Securities and Exchange Commission may be necessary if, among other matters, the auditor withdraws because the board of directors has not taken appropriate remedial action. Such failure may be a reportable disagreement on Form 8-K.

<sup>10</sup> In accordance with section 315, communications between predecessor and successor auditors require the specific permission of the client.

## **.34 Appendix**

### **Characteristics of Errors and Irregularities**

1. Characteristics of errors and irregularities that are relevant because of their potential influence on the auditor's ability to detect such matters are materiality of the effect on financial statements, level of management or employees involved, extent and skillfulness of any concealment, relationship to established specific control procedures, and the specific financial statements affected.

### **Materiality**

2. Section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .04, states that "financial statements are materially misstated when they contain errors or irregularities whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly in conformity with generally accepted accounting principles." Section 312.13, also states: "The auditor generally plans the audit primarily to detect errors that he believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements." As used in section 312, the term *errors* refers to both errors and irregularities.

3. In planning the audit, the auditor is concerned with matters that could be material to the financial statements. An audit in accordance with generally accepted auditing standards may detect errors or irregularities that are not material to the financial statements, but such an audit can provide no assurance of detecting immaterial errors or irregularities. In this regard, there is no important distinction between errors and irregularities. There is a distinction, however, in the auditor's response to detected matters. Generally, an isolated, immaterial error in processing accounting data or applying accounting principles is not significant to the audit. In contrast, detection of an irregularity requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

### **Level of Involvement**

4. An irregularity may be caused by an employee or by management and, if by management, by a relatively high or low level of management. The experience of auditors indicates that the level of involvement often combines with other characteristics in ways that have an influence on the auditor's ability to detect.

5. Defalcations by employees are often immaterial in amount and concealed in a manner that does not misstate net assets or net income. This type of irregularity can be more efficiently and effectively dealt with by an effective internal control structure and fidelity bonding of employees.

6. Material irregularities perpetrated by senior levels of management, including an owner-manager of a small business, are infrequent, but when they do occur they often engender widespread attention. These irregularities may not be susceptible to prevention or detection by specific control procedures because senior management is above the controls that deter employees or may override these controls with relative ease. Culture, custom, and the corporate governance system inhibit irregularities by senior management, but are not infallible deterrents. For this reason, an audit in accordance with generally accepted auditing standards necessarily gives due consideration to factors that bear on management integrity and the control environment.

## Concealment

7. Concealment is any attempt by the perpetrator of an irregularity to reduce the likelihood of detection. Concealment usually involves manipulation of accounting records or supporting documents to disguise the fact that the accounting records are not in agreement with the underlying facts and circumstances. Concealment can be skillful and elaborate or clumsy and limited. The auditor's ability to detect a concealed irregularity depends on the skillfulness of the perpetrator, the frequency and extent of manipulation, and the relative size of individual amounts manipulated.

8. Forgery may be used to create false signatures, other signs of authenticity, or entire documents. Collusion may result in falsified confirmations or other evidence of validity. Also, unrecorded transactions are normally more difficult to detect than concealment achieved by manipulation of recorded transactions. However, the effect of concealment on the ability to detect an irregularity is dependent on the particular circumstances. For example, an attempt to mislead users of financial statements by recording large, fictitious revenue transactions late in the period without supporting documentation would be more readily detected than fictitious revenue transactions spread throughout the period, individually immaterial in amount, and supported by legitimate-appearing invoices and shipping documents. Moreover, both of these irregularities might be extremely difficult, if not impossible, to detect if collusion of customers is added to the concealment scheme.

## Internal Control Structure

9. A lack of control procedures could permit an error or irregularity to occur repeatedly and the repeated occurrence could accumulate to a material amount. However, the auditor may not detect an error or irregularity that results from a nonrecurring breakdown of a specific control procedure because a rare item permitted by temporary conditions may not come to light in the performance of analytical or other procedures.

10. Irregularities may also be perpetrated or concealed by circumvention of specific control procedures or may be perpetrated by a level of management above specific control procedures. These types of irregularities are generally more difficult for an auditor to detect. However, the auditor should consider whether there are circumstances or factors that indicate a higher risk of these types of irregularities and modify auditing procedures accordingly.

## Financial Statement Effect

11. Other matters remaining equal, errors or irregularities that involve overstatement will generally be more readily detected than those that involve understatement because the audit evidence available is more reliable for detecting such errors or irregularities. Also, misstatements that are charged to the income statement are less likely to be detected than those that are concealed in the balance sheet, because the process of comparing recorded accountability with the existing assets should detect significant errors concealed in the balance sheet.

## Summary

12. The foregoing discussion considers characteristics of errors and irregularities individually and explains the effect an individual characteristic tends to have on the auditor's detection ability. However, these characteristics may interact in particular circumstances in ways that also affect the auditor's ability to detect a specific error or irregularity.

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[The next page is 251.]



## AU Section 317

### ***Illegal Acts By Clients***

(Supersedes section 328)

Source: SAS No. 54.

See section 9317 for interpretations of this section.

**Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.**

.01 This section prescribes the nature and extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards. The section also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

#### **Definition of Illegal Acts**

.02 The term *illegal acts*, for purposes of this section, refers to violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

#### **Dependence on Legal Judgment**

.03 Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. An auditor, in reporting on financial statements, presents himself as one who is proficient in accounting and auditing. The auditor's training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his attention may be illegal. However, the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

#### **Relation to Financial Statements**

.04 Illegal acts vary considerably in their relation to the financial statements. Generally, the further removed an illegal act is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of the act or to recognize its possible illegality.

.05 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts. However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statements assertions rather than from the perspective of legality *per se*. The auditor's responsibility to detect and report misstatements resulting from

illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and irregularities as described in section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.

.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. For example, securities may be purchased or sold based on inside information. While the direct effects of the purchase or sale may be recorded appropriately, their indirect effect, the possible contingent liability for violating securities laws, may not be appropriately disclosed. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

## **The Auditor's Consideration of the Possibility of Illegal Acts**

.07 As explained in paragraph .05, certain illegal acts have a direct and material effect on the determination of financial statement amounts. Other illegal acts, such as those described in paragraph .06, may, in particular circumstances, be regarded as having material but indirect effects on financial statements. The auditor's responsibility with respect to detecting, considering the financial statement effects of, and reporting these other illegal acts is described in this section. These other illegal acts are hereinafter referred to simply as *illegal acts*. The auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts explained above, an audit made in accordance with generally accepted auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

### **Audit Procedures in the Absence of Evidence Concerning Possible Illegal Acts**

.08 Normally, an audit in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts. However, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. For example, such procedures include reading minutes; inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; performing substantive tests of details of transactions or balances. The auditor should make inquiries of management concerning the

client's compliance with laws and regulations. Where applicable, the auditor should also inquire of management concerning—

- The client's policies relative to the prevention of illegal acts.
- The use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations.

The auditor also ordinarily obtains written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. (See section 333, *Client Representations*.) The auditor need perform no further procedures in this area absent specific information concerning possible illegal acts.

### Specific Information Concerning Possible Illegal Acts

.09 In applying audit procedures and evaluating the results of those procedures, the auditor may encounter specific information that may raise a question concerning possible illegal acts, such as the following:

- Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets
- Investigation by a governmental agency, an enforcement proceeding, or payment of unusual fines or penalties
- Violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor
- Large payments for unspecified services to consultants, affiliates, or employees
- Sales commissions or agents' fees that appear excessive in relation to those normally paid by the client or to the services actually received
- Unusually large payments in cash, purchases of bank cashiers' checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions
- Unexplained payments made to government officials or employees
- Failure to file tax returns or pay government duties or similar fees that are common to the entity's industry or the nature of its business

### Audit Procedures in Response to Possible Illegal Acts

.10 When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of management at a level above those involved, if possible. If management does not provide satisfactory information that there has been no illegal act, the auditor should—

- a. Consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with client's legal counsel should be made by the client.
- b. Apply additional procedures, if necessary, to obtain further understanding of the nature of the acts.

.11 The additional audit procedures considered necessary, if any, might include procedures such as the following:

- a. Examine supporting documents, such as invoices, canceled checks, and agreements and compare with accounting records.
- b. Confirm significant information concerning the matter with the other party to the transaction or with intermediaries, such as banks or lawyers.
- c. Determine whether the transaction has been properly authorized.
- d. Consider whether other similar transactions or events may have occurred, and apply procedures to identify them.

## **The Auditor's Response to Detected Illegal Acts**

.12 When the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

## **The Auditor's Consideration of Financial Statement Effect**

.13 In evaluating the materiality of an illegal act that comes to his attention, the auditor should consider both the quantitative and qualitative materiality of the act. For example, section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .07, states that "an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue."

.14 The auditor should consider the effect of an illegal act on the amounts presented in financial statements including contingent monetary effects, such as fines, penalties and damages. Loss contingencies resulting from illegal acts that may be required to be disclosed should be evaluated in the same manner as other loss contingencies. Examples of loss contingencies that may arise from an illegal act are: threat of expropriation of assets, enforced discontinuance of operations in another country, and litigation.

.15 The auditor should evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations. If material revenue or earnings are derived from transactions involving illegal acts, or if illegal acts create significant unusual risks associated with material revenue or earnings, such as loss of a significant business relationship, that information should be considered for disclosure.

## **Implications for Audit**

.16 The auditor should consider the implications of an illegal act in relation to other aspects of the audit, particularly the reliability of representations of management. The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved.

## **Communication With the Audit Committee**

.17 The auditor should assure himself that the audit committee, or others with equivalent authority and responsibility, is adequately informed with

respect to illegal acts that come to the auditor's attention.<sup>1</sup> The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and the effect on the financial statements. Senior management may wish to have its remedial actions communicated to the audit committee simultaneously. Possible remedial actions include disciplinary action against involved personnel, seeking restitution, adoption of preventive or corrective company policies, and modifications of specific control procedures. If senior management is involved in an illegal act, the auditor should communicate directly with the audit committee. The communication may be oral or written. If the communication is oral, the auditor should document it.

### **Effect on the Auditor's Report**

.18 If the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified opinion or an adverse opinion on the financial statements taken as a whole, depending on the materiality of the effect on the financial statements.

.19 If the auditor is precluded by the client from obtaining sufficient competent evidential matter to evaluate whether an illegal act that could be material to the financial statements has, or is likely to have, occurred, the auditor generally should disclaim an opinion on the financial statements.

.20 If the client refuses to accept the auditor's report as modified for the circumstances described in paragraphs .18 and .19, the auditor should withdraw from the engagement and indicate the reasons for withdrawal in writing to the audit committee or board of directors.

.21 The auditor may be unable to determine whether an act is illegal because of limitations imposed by the circumstances rather than by the client or because of uncertainty associated with interpretation of applicable laws or regulations or surrounding facts. In these circumstances, the auditor should consider the effect on his report.<sup>2</sup>

### **Other Considerations in an Audit in Accordance With Generally Accepted Auditing Standards**

.22 In addition to the need to withdraw from the engagement, as described in paragraph .20, the auditor may conclude that withdrawal is necessary when the client does not take the remedial action that the auditor considers necessary in the circumstances even when the illegal act is not material to the financial statements. Factors that should affect the auditor's conclusion include the implications of the failure to take remedial action, which may affect the auditor's ability to rely on management representations, and the effects of continuing association with the client. In reaching a conclusion on such matters, the auditor may wish to consult with his own legal counsel.

.23 Disclosure of an illegal act to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by

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<sup>1</sup> For entities that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

<sup>2</sup> See section 508, *Reports on Audited Financial Statements*.

the auditor's ethical or legal obligation of confidentiality, unless the matter affects his opinion on the financial statements. The auditor should recognize, however, that in the following circumstances a duty to notify parties outside the client may exist:

- a. When the entity reports an auditor change under the appropriate securities law on Form 8-K<sup>3</sup>
- b. To a successor auditor when the successor makes inquiries in accordance with section 315, *Communications Between Predecessor and Successor Auditors*<sup>4</sup>
- c. In response to a subpoena
- d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing illegal acts with parties outside the client.

## Responsibilities in Other Circumstances

.24 An auditor may accept an engagement that entails a greater responsibility for detecting illegal acts than that specified in this section. For example, a governmental unit may engage an independent auditor to perform an audit in accordance with the Single Audit Act of 1984. In such an engagement, the independent auditor is responsible for testing and reporting on the governmental unit's compliance with certain laws and regulations applicable to Federal financial assistance programs. Also, an independent auditor may undertake a variety of other special engagements. For example, a corporation's board of directors or its audit committee may engage an auditor to apply agreed-upon procedures and report on compliance with the corporation's code of conduct under the attestation standards.

## Effective Date

.25 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

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[The next page is 259.]

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<sup>3</sup> Disclosure to the Securities and Exchange Commission may be necessary if, among other matters, the auditor withdraws because the board of directors has not taken appropriate remedial action. Such failure may be a reportable disagreement on Form 8-K.

<sup>4</sup> In accordance with section 315, communications between predecessor and successor auditors require the specific permission of the client.

## AU Section 9317

### ***Illegal Acts by Clients: Auditing Interpretations of Section 317***

#### **1. Consideration of the Internal Control Structure in a Financial Statement Audit and the Foreign Corrupt Practices Act**

**.01 Question**—The second standard of field work requires the auditor to obtain a sufficient understanding of the internal control structure to plan the audit and to determine the nature, timing, and extent of tests to be performed. Is the auditor of an entity subject to the Securities Exchange Act of 1934 required, because of the *Foreign Corrupt Practices Act of 1977* and the provisions of section 317, to expand his consideration of the internal control structure beyond that which is required by the second standard of field work?

**.02 Interpretation**—No. There is nothing in the Act or the related legislative history that purports to alter the auditor's duty to his client or the purpose of his consideration of the internal control structure. The Act creates express new duties only for companies subject to the Securities Exchange Act of 1934, not for auditors.

[Issue Date: October, 1978.]

#### **2. Material Weaknesses in the Internal Control Structure and the Foreign Corrupt Practices Act**

**.03 Question**—What course of action should be followed by the auditor of an entity subject to the internal accounting control provision of the *Foreign Corrupt Practices Act of 1977* to comply with section 317 when a material weakness in the internal control structure comes to his attention?

**.04 Interpretation**—The standards applied by an auditor in determining a material weakness in the internal control structure may differ from the standards for determining a violation of the Act. Nevertheless, a specific material weakness may ultimately be determined to be a violation and, hence, an illegal act. Therefore, the auditor should inquire of the client's management and consult with the client's legal counsel as to whether the material weakness is a violation of the Act.

**.05** In consultation with management and legal counsel, consideration should be given to corrective action taken or in process. If management has concluded that corrective action for a material weakness is not practicable, consideration should be given to the reasons underlying that conclusion, including management's evaluation of the costs of correction in relation to the expected benefit to be derived.<sup>1</sup> If it is determined that there has been a violation of the Act and appropriate consideration is not given to the violation,

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<sup>1</sup> The legislative history of the Act indicates that cost-benefit considerations are appropriate in determining compliance with the accounting provisions of the Act. For example, the Senate committee report stated that "the size of the business, diversity of operations, degree of centralization of financial and operating management, amount of contact by top management with day-

the auditor should consider withdrawing from the current engagement or dissociating himself from any future relationship with the client (see section 317.22).

.06 A violation of the internal accounting control provision of the Act would not, in and of itself, have a direct effect on amounts presented in audited financial statements. However, the contingent monetary effect on an entity ultimately determined to have willfully violated the internal accounting control provision of the Act could be fines of up to \$10,000 for the violation. The auditor should consider the materiality of such contingent monetary effect in relation to the audited financial statements taken as a whole. Other loss contingencies, as defined by FASB Statement No. 5 [AC section C59], ordinarily would not result from a weakness in the internal control structure which gives rise to such a violation of the Act.

[Issue Date: October, 1978.]

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[The next page is 265.]

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(Footnote Continued)

to-day operations, and numerous other circumstances are factors which management must consider in establishing and maintaining an internal accounting control system."



## AU Section 319

### ***Consideration of the Internal Control Structure in a Financial Statement Audit***

(Supersedes section 320) \*

Source: SAS No. 55.

Effective for audits of financial statements for periods beginning on or after January 1, 1990, unless otherwise indicated.

.01 This section provides guidance on the independent auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards.<sup>1</sup> It describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit.

#### **Summary**

.02 An entity's internal control structure, for purposes of this section, consists of three elements: the control environment, the accounting system, and control procedures. In all audits, the auditor should obtain a sufficient understanding of each of the three elements to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

.03 After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure) because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidential matter about the effectiveness of both the design and operation of a policy or procedure that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.

.04 After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be

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\* This section also supersedes Auditing Interpretations of section 320, *The Auditor's Study and Evaluation of Internal Control* (section 9320.01—.06).

<sup>1</sup> This section revises the second standard of fieldwork of the ten generally accepted auditing standards as follows:

A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

.05 The auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

## Elements of an Internal Control Structure

.06 An entity's internal control structure consists of the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. Although the internal control structure may include a wide variety of objectives and related policies and procedures, only some of these may be relevant to an audit of the entity's financial statements. Generally, the policies and procedures that are relevant to an audit pertain to the entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the financial statements.<sup>2</sup> Other policies and procedures, however, may be relevant if they pertain to data the auditor uses to apply auditing procedures. For example, policies and procedures pertaining to nonfinancial data that the auditor uses in analytical procedures, such as production statistics, may be relevant in an audit.

.07 An entity generally has internal control structure policies and procedures that are not relevant to an audit and therefore need not be considered. For example, policies and procedures concerning the effectiveness, economy, and efficiency of certain management decision-making processes, such as the appropriate price to charge for its products, or whether to make expenditures for certain research and development or advertising activities, although important to the entity, do not ordinarily relate to a financial statement audit.

.08 For purposes of an audit of financial statements, an entity's internal control structure consists of the three following elements:

- The control environment
- The accounting system
- Control procedures

Dividing the internal control structure into these three elements facilitates discussion of its nature and how the auditor considers it in an audit. The auditor's primary consideration, however, is whether an internal control structure policy or procedure affects financial statement assertions rather than its classification into any particular category.

## Control Environment

.09 The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include the following:

- Management's philosophy and operating style
- The entity's organizational structure
- The functioning of the board of directors and its committees, particularly the audit committee
- Methods of assigning authority and responsibility

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<sup>2</sup> The terms *financial statement assertions* and *assertions* are used throughout this section to refer to the five categories of management's assertions that are embodied in the account balance, transaction class, and disclosure components of financial statements as discussed in section 326, *Evidential Matter*, paragraphs .03—.08.

- Management's control methods for monitoring and following up on performance, including internal auditing
- Personnel policies and practices
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies

The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity. (The control environment factors are discussed in greater detail in paragraph .66.)

### **Accounting System**

.10 The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

### **Control Procedures**

.11 Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Generally, they may be categorized as procedures that pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties that reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure the proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail

of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

### General Considerations

.12 The applicability and importance of specific control environment factors, accounting system methods and records, and control procedures that an entity establishes should be considered in the context of—

- The entity's size.
- Its organization and ownership characteristics.
- The nature of its business.
- The diversity and complexity of its operations.
- Its methods of processing data.
- Its applicable legal and regulatory requirements.

For example, a formal written code of conduct or an organizational structure that provides for formal delegation of authority may be significant to the control environment of a large entity. However, a small entity with effective owner-manager involvement may not need a formal code or organizational structure. Similarly, a small entity with effective owner-manager involvement may not need extensive accounting procedures, sophisticated accounting records, or formal control procedures, such as a formal credit policy, information security policy, or competitive bidding procedures.

.13 Establishing and maintaining an internal control structure is an important management responsibility. To provide reasonable assurance that an entity's objectives will be achieved, the internal control structure should be under ongoing supervision by management to determine that it is operating as intended and that it is modified as appropriate for changes in conditions.

.14 The concept of reasonable assurance recognizes that the cost of an entity's internal control structure should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship is a primary criterion that should be considered in designing an internal control structure, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship.

.15 The potential effectiveness of an entity's internal control structure is subject to inherent limitations. Mistakes in the application of policies and procedures may arise from such causes as misunderstanding of instructions, mistakes in judgment, and personal carelessness, distraction, or fatigue. Furthermore, the policies and procedures that require segregation of duties can be circumvented by collusion among persons both within and outside the entity and by management override of certain policies or procedures.

### Consideration of the Internal Control Structure in Planning an Audit

.16 The auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure to plan the audit of the entity's financial statements. The understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to—

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatements.

- Design substantive tests.

.17 Whether an internal control structure policy or procedure has been *placed in operation* is different from its *operating effectiveness*. In obtaining knowledge about whether policies, procedures, or records have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the policy, procedure, or record was applied, the consistency with which it was applied, and by whom. This section does not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure.

.18 The auditor's understanding of the internal control structure may sometimes raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentations in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

## Understanding the Internal Control Structure

.19 In making a judgment about the understanding of the internal control structure necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatements that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests. Other sources of such knowledge include previous audits and the understanding of the industry in which the entity operates. The auditor also considers his assessments of inherent risk, his judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including whether the method of controlling data processing is based on manual procedures independent of the computer or is highly dependent on computerized controls. As an entity's operations and systems become more complex and sophisticated, it may be necessary to devote more attention to internal control structure elements to obtain the understanding of them that is necessary to design effective substantive tests. For example, when auditing past due loans of a financial institution that uses computer-produced reports of such loans, the auditor may be unable to design appropriate substantive tests without knowledge of the specific control procedures concerning the completeness and classification of loans.

## Understanding of Control Environment

.20 The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment. The auditor should concentrate on the substance of management's policies, procedures, and related actions rather than their form because management may establish appropriate policies and procedures but not act on them. For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. Similarly, management may establish a formal code of conduct but act in a manner that condones violations of that code.

### Understanding of Accounting System

.21 The auditor should obtain sufficient knowledge of the accounting system to understand—

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated.
- The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

### Understanding of Control Procedures

.22 Because some control procedures are integrated in specific components of the control environment and accounting system, as the auditor obtains an understanding of the control environment and accounting system, he is also likely to obtain knowledge about some control procedures. For example, in obtaining an understanding of the documents, records, and processing steps in the accounting system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether it is necessary to devote additional attention to obtaining an understanding of control procedures to plan the audit. Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to those components.

### Procedures to Obtain Understanding

.23 In obtaining an understanding of the internal control structure policies and procedures that are relevant to audit planning, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant policies, procedures, and records pertaining to each of the three internal control structure elements and whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular policy or procedure, and the nature of the entity's documentation of specific policies and procedures.

.24 For example, the auditor's prior experience with the entity may provide an understanding of its classes of transactions. Inquiries of appropriate entity personnel and inspection of documents and records, such as source documents, journals, and ledgers, may provide an understanding of the accounting records designed to process those transactions and whether they have been placed in operation. Similarly, in obtaining an understanding of the

design of computer-programmed control procedures and whether they have been placed in operation, the auditor may make inquiries of appropriate entity personnel and inspect relevant systems documentation to understand control procedure design and may inspect exception reports generated as a result of such control procedures to determine that they have been placed in operation.

.25 The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of the internal control structure.

### Documentation of Understanding

.26 The auditor should document the understanding of the entity's internal control structure elements obtained to plan the audit. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's internal control structure. For example, documentation of the understanding of the internal control structure of a large complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, documentation in the form of a memorandum may be sufficient. Generally, the more complex the internal control structure and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

## Consideration of the Internal Control Structure in Assessing Control Risk

.27 Section 326, *Evidential Matter*, states that most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

In planning and performing an audit, an auditor considers these assertions in the context of their relationship to a specific account balance or class of transactions.

.28 The risk of material misstatement<sup>3</sup> in financial statement assertions consists of inherent risk, control risk, and detection risk. Inherent risk is the susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures. Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control

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<sup>3</sup> For purposes of this section, a material misstatement in a financial statement assertion is an error or irregularity as defined in section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, that either individually or when aggregated with other errors or irregularities in other assertions would be material to the financial statements taken as a whole.

structure policies or procedures. Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion.

**.29** Assessing control risk is the process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions. After obtaining the understanding of the internal control structure, the auditor may assess control risk at the maximum level for some or all assertions because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.<sup>4</sup>

**.30** Assessing control risk at below the maximum level involves—

- Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.
- Performing tests of controls to evaluate the effectiveness of such policies and procedures.

**.31** In identifying internal control structure policies and procedures relevant to specific financial statement assertions, the auditor should consider that the policies and procedures can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular internal control structure element involved. The control environment and accounting system often have a pervasive effect on a number of account balances or transaction classes and, therefore, can often affect many assertions. For example, the conclusion that an entity's control environment is highly effective may influence the auditor's decision about the number of an entity's locations at which auditing procedures are to be performed or whether to perform certain auditing procedures for some account balances or transaction classes at an interim date. Either decision affects the way in which auditing procedures are applied to specific assertions, even though the auditor may not have specifically considered each individual assertion that is affected by such decisions.

**.32** Conversely, some control procedures often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control procedures that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

**.33** Internal control structure policies and procedures can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that policy or procedure may be in reducing control risk for that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing control risk for that assertion than policies and procedures more directly related to that assertion, such as matching shipping documents with billing documents.

**.34** Procedures directed toward either the effectiveness of the design or operation of an internal control structure policy or procedure are referred to as

<sup>4</sup> Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range, for example, from a maximum to a minimum. The term *maximum level* is used in this section to mean the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.



tests of controls. Tests of controls directed toward the effectiveness of the design of an internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific internal control structure policies and procedures. For entities with a complex internal control structure, the auditor should consider that the use of flowcharts, questionnaires, or decision tables might facilitate the application of tests of design.

**.35** Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports indicating performance of the policy or procedure, observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure by the auditor. In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of an internal control structure policy or procedure.

**.36** The conclusion reached as a result of assessing control risk is referred to as the *assessed level of control risk*. In determining the evidential matter necessary to support a specific assessed level of control risk at below the maximum level, the auditor should consider the characteristics of evidential matter about control risk discussed in paragraphs .46 through .60. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the internal control structure policies and procedures relevant to an assertion are designed and operating effectively.

**.37** The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures to be used to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are referred to in this section as substantive tests.

**.38** As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase. Consequently, the auditor may do one or more of the following:

- Change the nature of substantive tests from a less effective to a more effective procedure, such as using tests directly toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity.
- Change the timing of substantive tests, such as performing them at year end rather than at an interim date.
- Change the extent of substantive tests, such as using a larger sample size.

### **Documentation of the Assessed Level of Control Risk**

**.39** In addition to the documentation of the understanding of the internal control structure discussed in paragraph .26, the auditor should document the basis for his conclusions about the assessed level of control risk. Conclusions

about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for his conclusion that the effectiveness of the design and operation of internal control structure policies and procedures supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control structure, and the nature of the entity's documentation of its internal control structure.

## **Relationship of Understanding to Assessing Control Risk**

**.40** Although understanding the internal control structure and assessing control risk are discussed separately in this section, they may be performed concurrently in an audit. The objective of procedures performed to obtain an understanding of the internal control structure (discussed in paragraphs .23 through .25) is to provide the auditor with knowledge necessary for audit planning. The objective of tests of controls (discussed in paragraphs .34 through .35) is to provide the auditor with evidential matter to use in assessing control risk. However, procedures performed to achieve one objective may also pertain to the other objective.

**.41** Based on the assessed level of control risk the auditor expects to support and audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining the understanding of the internal control structure. In addition, even though some of the procedures performed to obtain the understanding may not have been specifically planned as tests of controls, they may also provide evidential matter about the effectiveness of both the design and operation of the policies and procedures relevant to certain assertions and, consequently, serve as tests of controls. For example, in obtaining an understanding of the control environment, the auditor may have made inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of variances between budgeted and actual amounts. Although these procedures provide knowledge about the design of the entity's budgeting policies and whether they have been placed in operation, they may also provide evidential matter about the effectiveness of the design and operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses. In some circumstances, that evidential matter may be sufficient to support an assessed level of control risk that is below the maximum level for the presentation and disclosure assertions pertaining to expenses in the income statement.

**.42** When the auditor concludes that procedures performed to obtain the understanding of the internal control structure also provide evidential matter for assessing control risk, he should consider the guidance in paragraphs .46 through .60 in judging the degree of assurance provided by that evidential matter. Although such evidential matter may not provide sufficient assurance to support an assessed level of control risk that is below the maximum level of certain assertions, it may do so for other assertions and thus provide a basis for modifying the nature, timing, or extent of the substantive tests that the auditor plans for those assertions. However, such procedures are not sufficient to support an assessed level of control risk below the maximum level if they do

not provide sufficient evidential matter to evaluate the effectiveness of both the design and operation of a policy or procedure relevant to an assertion.

### **Further Reduction in the Assessed Level of Control Risk**

.43 After obtaining the understanding of the internal control structure and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of the internal control structure, as well as pertinent information from other sources, help the auditor to evaluate those two factors.

.44 In considering efficiency, the auditor recognizes that additional evidential matter that supports a further reduction in the assessed level of control risk for an assertion would result in less audit effort for the substantive tests of that assertion. The auditor weighs the increase in audit effort associated with the additional tests of controls that is necessary to obtain such evidential matter against the resulting decrease in audit effort associated with the reduced substantive tests. When the auditor concludes it is inefficient to obtain additional evidential matter for specific assertions, the auditor uses the assessed level of control risk based on the understanding of the internal control structure in planning the substantive tests for those assertions.

.45 For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

### **Evidential Matter to Support the Assessed Level of Control Risk**

.46 When the auditor assesses control risk at below the maximum level, he should obtain sufficient evidential matter to support that assessed level. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditing judgment. Evidential matter varies substantially in the assurance it provides to the auditor as he develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads, all bear on the degree of assurance evidential matter provides.

.47 These characteristics influence the nature, timing, and extent of the tests of controls that the auditor applies to obtain evidential matter about control risk. The auditor selects such tests from a variety of techniques such as inquiry, observation, inspection, and reperformance of a policy or procedure that pertains to an assertion. No one specific test of controls is always necessary, applicable, or equally effective in every circumstance.

### **Type of Evidential Matter**

.48 The nature of the particular policies and procedures that pertain to an assertion influences the type of evidential matter that is available to evaluate the effectiveness of the design or operation of those policies and procedures. For some policies and procedures, documentation of design or

operation may exist. In such circumstances, the auditor may decide to inspect the documentation to obtain evidential matter about the effectiveness of design or operation.

.49 For other policies and procedures, however, such documentation may not be available or relevant. For example, documentation of design or operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control procedures, such as segregation of duties or some control procedures performed by a computer. In such circumstances, evidential matter about the effectiveness of design or operation may be obtained through observation or the use of computer-assisted audit techniques to reperform the application of relevant policies and procedures.

### **Source of Evidential Matter**

.50 Generally, evidential matter about the effectiveness of the design and operation of policies and procedures obtained directly by the auditor, such as through observation, provides more assurance than evidential matter obtained indirectly or by inference, such as through inquiry. For example, evidential matter about the proper segregation of duties that is obtained by the auditor's direct personal observation of the individual who applies a control procedure generally provides more assurance than making inquiries about the individual. The auditor should consider, however, that the observed application of a policy or procedure might not be performed in the same manner when the auditor is not present.

.51 Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control procedure. When the auditor determines that a specific control procedure may have a significant effect in reducing control risk to a low level for a specific assertion, he ordinarily needs to perform additional tests to obtain sufficient evidential matter to support the conclusion about the effectiveness of the design or operation of that control procedure.

### **Timeliness of Evidential Matter**

.52 The timeliness of the evidential matter concerns when it was obtained and the portion of the audit period to which it applies. In evaluating the degree of assurance that is provided by evidential matter, the auditor should consider that the evidential matter obtained by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such evidential matter may be insufficient to evaluate the effectiveness of the design or operation of internal control structure policies and procedures for periods not subjected to such tests. In such circumstances, the auditor may decide to supplement these tests with other tests of controls that are capable of providing evidential matter about the entire audit period. For example, for a control procedure performed by a computer program, the auditor may test the operation of the control at a particular point in time to obtain evidential matter about whether the program executes the control effectively. The auditor may then perform tests of controls directed toward the design and operation of other control procedures pertaining to the modification and the use of that computer program during the audit period to obtain evidential matter about whether the programmed control procedure operated consistently during the audit period.

.53 Evidential matter about the effective design or operation of internal control structure policies and procedures that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit.

To evaluate the use of such evidential matter for the current audit, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the prior audits, the degree to which the effective design and operation of those policies and procedures were evaluated, the results of the tests of controls used to make those evaluations, and the evidential matter about design or operation that may result from substantive tests performed in the current audit. The auditor should also consider that the longer the time elapsed since the performance of tests of controls to obtain evidential matter about control risk, the less assurance it may provide.

**.54** When considering evidential matter obtained from prior audits, the auditor should obtain evidential matter in the current period about whether changes have occurred in the internal control structure, including its policies, procedures, and personnel, subsequent to the prior audits, as well as the nature and extent of any such changes. Consideration of evidential matter about these changes, together with the considerations in the preceding paragraph, may support either increasing or decreasing the additional evidential matter about the effectiveness of design and operation to be obtained in the current period.

**.55** When the auditor obtains evidential matter about the design or operation of internal control structure policies and procedures during an interim period, he should determine what additional evidential matter should be obtained for the remaining period. In making that determination, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the interim period, the degree to which the effective design and operation of those policies and procedures were evaluated, the results of the tests of controls used to make that evaluation, the length of the remaining period, and the evidential matter about design or operation that may result from the substantive test performed in the remaining period. The auditor should obtain evidential matter about the nature and extent of any significant changes in the internal control structure, including its policies, procedures, and personnel, that occur subsequent to the interim period.

### **Interrelationship of Evidential Matter**

**.56** The auditor should consider the combined effect of various types of evidential matter relating to the same assertion in evaluating the degree of assurance that evidential matter provides. In some circumstances, a single type of evidential matter may not be sufficient to evaluate the effective design or operation of an internal control structure policy or procedure. To obtain sufficient evidential matter in such circumstances, the auditor may perform other tests of controls pertaining to that policy or procedure. For example, an auditor may observe that programmers are not authorized to operate the computer. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with inquiries about the frequency and circumstances under which programmers may have access to the computer and may inspect documentation of past instances when programmers attempted to operate the computer to determine how such attempts were prevented or detected.

**.57** In addition, when evaluating the degree of assurance provided by evidential matter, the auditor should consider the interrelationship of an entity's control environment, accounting system, and control procedures. Although an individual internal control structure element may affect the nature, timing, or extent of substantive tests for a specific financial statement

assertion, the auditor should consider the evidential matter about an individual element in relation to the evidential matter about the other elements in assessing control risk for a specific assertion.

**.58** Generally, when various types of evidential matter support the same conclusion about the design or operation of an internal control structure policy or procedure, the degree of assurance provided increases. Conversely, if various types of evidential matter lead to different conclusions about the design or operation of an internal control structure policy or procedure, the assurance provided decreases. For example, based on the evidential matter that the control environment is effective, the auditor may have reduced the number of locations at which auditing procedures will be performed. If, however, when evaluating specific control procedures, the auditor obtains evidential matter that such procedures are ineffective, he may reevaluate his conclusion about the control environment and, among other things, decide to perform auditing procedures at additional locations.

**.59** Similarly, evidential matter indicating that the control environment is ineffective may adversely affect an otherwise effective accounting system or control procedure for a particular assertion. For example, a control environment that is likely to permit unauthorized changes in a computer program may reduce the assurance provided by evidential matter obtained from evaluating the effectiveness of the program at a particular point in time. In such circumstances, the auditor may decide to obtain additional evidential matter about the design and operation of that program during the audit period. For example, the auditor might obtain and control a copy of the program and use computer-assisted audit techniques to compare that copy with the program that the entity uses to process data.

**.60** An audit of financial statements is a cumulative process; as the auditor assesses control risk, the information obtained may cause him to modify the nature, timing, or extent of the other planned tests of controls for assessing control risk. In addition, information may come to the auditor's attention as a result of performing substantive tests or from other sources during the audit that differs significantly from the information on which his planned tests of controls for assessing control risk were based. For example, the extent of misstatements that the auditor detects by performing substantive tests may alter his judgment about the assessed level of control risk. In such circumstances, the auditor may need to reevaluate the planned substantive procedures, based on a revised consideration of the assessed level of control risk for all or some of the financial statement assertions.

## **Correlation of Control Risk With Detection Risk**

**.61** The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that material misstatements exist in the financial statements. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such misstatements may exist in the financial statements. The auditor uses this evidential matter as part of the reasonable basis for an opinion referred to in the third standard of field work, which follows:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

**.62** After considering the level to which he seeks to restrict the risk of a material misstatement in the financial statements and the assessed levels of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed level of control

risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the substantive tests performed.

**.63** Although the inverse relationship between control risk and detection risk may permit the auditor to change the nature or the timing of substantive tests or limit their extent, ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transaction classes. Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes.

**.64** The substantive tests that the auditor performs consist of tests of details of transactions and balances, and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions performed as tests of controls is to evaluate whether an internal control structure policy or procedure operated effectively. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction. The auditor should recognize, however, that careful consideration should be given to the design and evaluation of such tests to ensure that both objectives will be accomplished.

## **Effective Date**

**.65** This section is effective for audits of financial statements for periods beginning on or after January 1, 1990. Early application of the provisions of this section is permissible.

## **Appendix A**

### **.66 Control Environment Factors**

1. This appendix discusses the control environment factors identified in paragraph .09.

#### **Management Philosophy and Operating Style**

2. Management philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's approach to taking and monitoring business risks; management's attitudes and actions toward financial reporting; and management's emphasis on meeting budget, profit, and other financial and operating goals. These characteristics have a significant influence on the control environment, particularly when management is dominated by one or a few individuals, regardless of the consideration given to the other control environment factors.

#### **Organizational Structure**

3. An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. An organizational structure includes consideration of the form and nature of an entity's organizational units, including the data processing organization, and related management functions and reporting relationships. In addition, the organizational structure should assign authority and responsibility within the entity in an appropriate manner.

#### **Audit Committee**

4. An effective audit committee takes an active role in overseeing an entity's accounting and financial reporting policies and practices. The committee should assist the board of directors in fulfilling its fiduciary and accountability responsibilities and should help maintain a direct line of communication between the board and the entity's external and internal auditors.

#### **Methods of Assigning Authority and Responsibility**

5. These methods affect the understanding of reporting relationships and responsibilities established within the entity. Methods of assigning authority and responsibility include consideration of—

- Entity policy regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct.
- Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- Employee job descriptions delineating specific duties, reporting relationships, and constraints.
- Computer systems documentation indicating the procedures for authorizing transactions and approving systems changes.

#### **Management Control Methods**

6. These methods affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise overall company activities. Management control methods include consideration of—

- Establishing planning and reporting systems that set forth management's plans and the results of actual performance. Such systems



may include business planning; budgeting, forecasting, and profit planning; and responsibility accounting.

- Establishing methods that identify the status of actual performance and exceptions from planned performance, as well as communicating them to the appropriate levels of management.
- Using such methods at appropriate management levels to investigate variances from expectations and to take appropriate and timely corrective action.
- Establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files.

### **Internal Audit Function**

7. The internal audit function is established within an entity to examine and evaluate the adequacy and effectiveness of other internal control structure policies and procedures. Establishing an effective internal audit function includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources.\*

### **Personnel Policies and Practices**

8. These policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Personnel policies and practices include consideration of an entity's policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

### **External Influences**

9. These are influences established and exercised by parties outside an entity that affect an entity's operations and practices. They include monitoring and compliance requirements imposed by legislative and regulatory bodies, such as examinations by bank regulatory agencies. They also include review and follow-up by parties outside the entity concerning entity actions. External influences are ordinarily outside an entity's authority. Such influences, however, may heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may also prompt management to establish specific internal control structure policies or procedures.

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\* Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance about factors that affect the auditor's consideration of the work of internal auditors in an audit.

## Appendix B

### .67 Glossary of Selected Terms and Concepts

**Accounting system** The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

**Assertions** Management representations that are embodied in the account balance, transaction class, and disclosure components of financial statements. They include (1) existence or occurrence, (2) completeness, (3) rights and obligations, (4) valuation or allocation and (5) presentation and disclosure.

**Assessed level of control risk** The level of control risk the auditor uses in determining the detection risk to accept for a financial statement assertion and, accordingly, in determining the nature, timing, and extent of substantive tests. This level may vary along a range from maximum to minimum as long as the auditor has obtained evidential matter to support that assessed level.

**Assessing control risk** The process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting misstatements in financial statement assertions.

**Control environment** The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include (1) management philosophy and operating style, (2) organizational structure, (3) the function of the board of directors and its committees, (4) methods of assigning authority and responsibility, (5) management control methods, (6) the internal audit function, (7) personnel policies and practices, and (8) external influences concerning the entity.

**Control procedures** The policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved.

**Control risk** The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure policies or procedures.

**Detection risk** The risk that the auditor will not detect a material misstatement that exists in an assertion.

**Inherent risk** The susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures.

**Internal control structure** The policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved.

**Internal control structure policies and procedures relevant to an audit** The policies and procedures in an entity's internal control structure that pertain to the entity's ability to record, process, summarize, and report financial data consistent with management's assertions embodied in the financial statements or that pertain to data the auditor uses to apply auditing procedures to financial statement assertions.

**Maximum level of control risk** The greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

**Operating effectiveness** How an internal control structure policy or procedure was applied, the consistency with which it was applied, and by whom.

**Placed in operation** An entity is using an internal control structure policy or procedure.

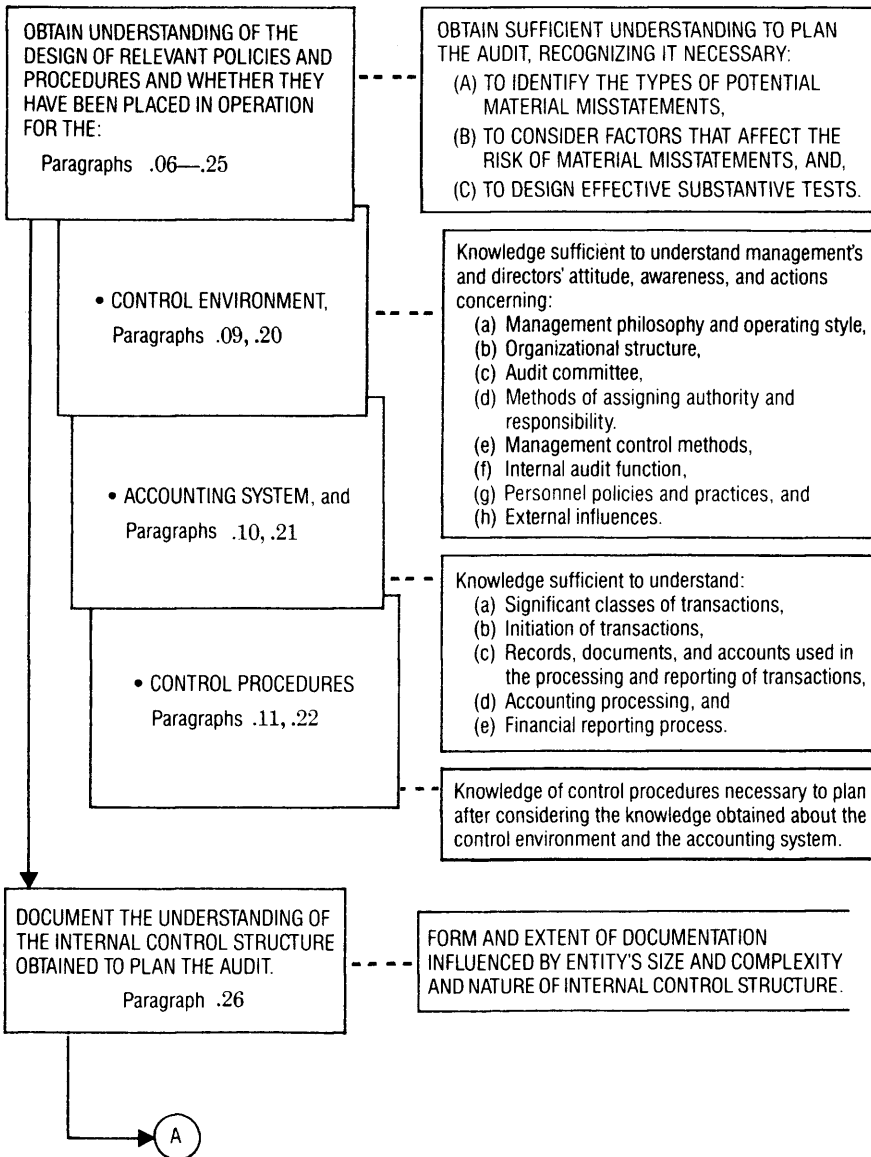
**Substantive tests** Tests of details and analytical procedures performed to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements.

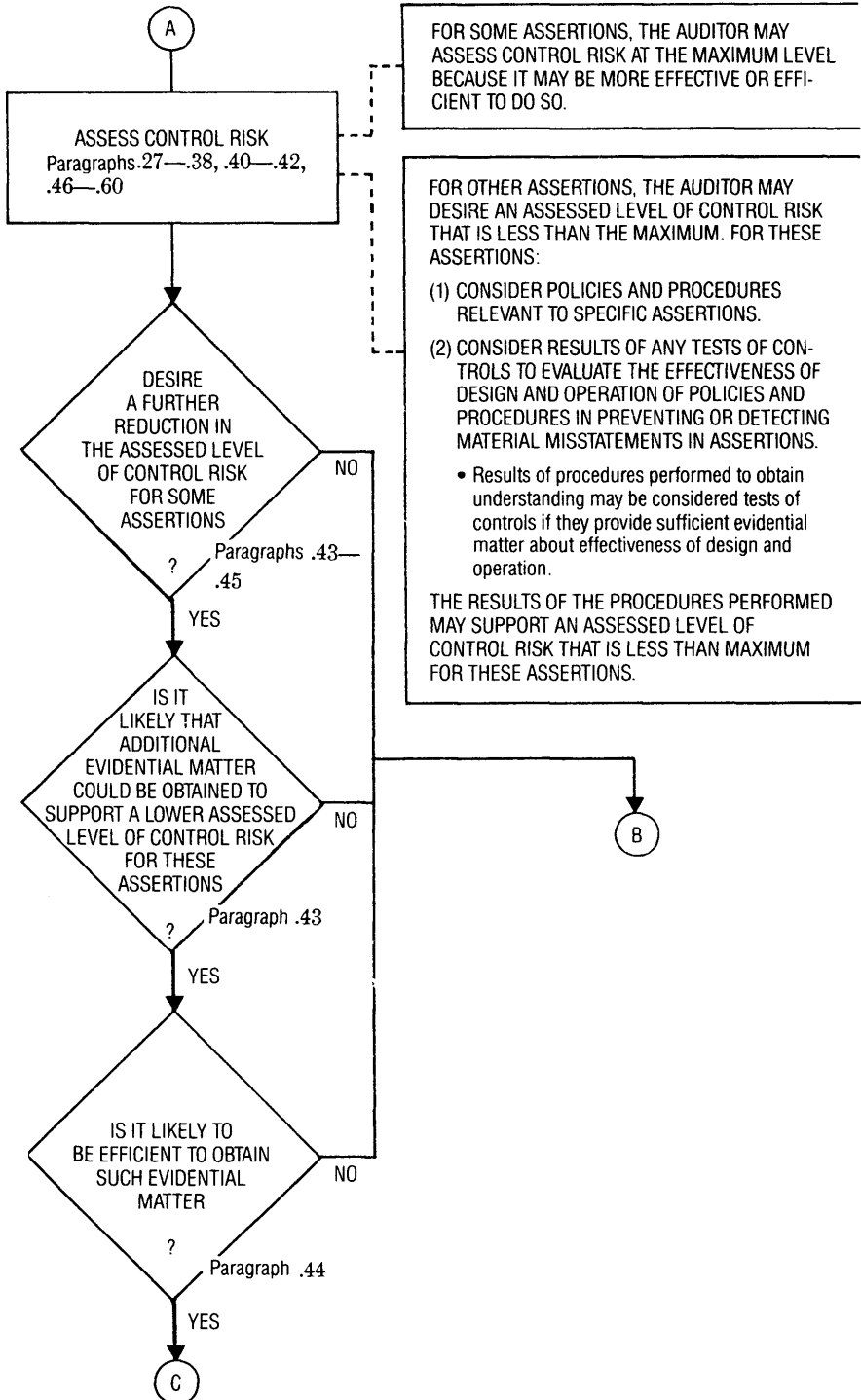
**Tests of controls** Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

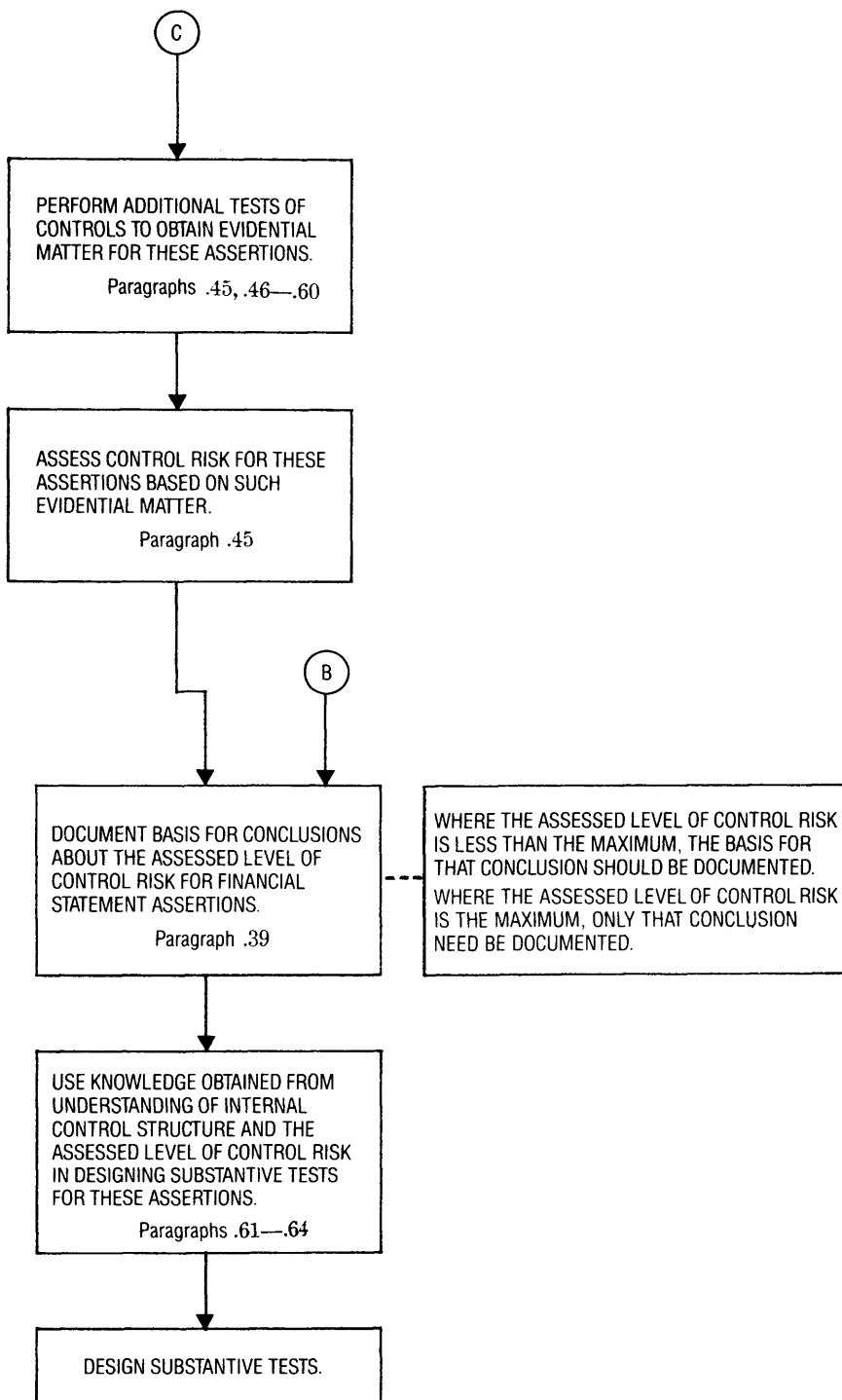
**Understanding of the internal control structure** The knowledge of the control environment, accounting system, and control procedures that the auditor believes is necessary to plan the audit.

## Appendix C

### .68 Flow Chart—Consideration of the Internal Control Structure in a Financial Statement Audit







## Appendix D

### .69 Other Selected Management Control Objectives

1. The concepts and terminology introduced in this section clarify and update former SAS No. 1, section 320, *The Auditor's Study and Evaluation of Internal Control*, by incorporating the concepts concerning audit evidence and audit risk that have evolved in practice and that have been established by Statements on Auditing Standards issued subsequent to that section. This appendix discusses some of the basic concepts in SAS No. 1, section 320, that are implicit in an internal control structure but that are not explicitly discussed in this section. Although these concepts have general application, the organizational and procedural means for applying them may differ considerably from case to case because of the variety of circumstances involved.

#### Management Objectives

2. Establishing and maintaining an internal control structure is an important management responsibility. In establishing specific internal control structure policies and procedures concerning an entity's ability to record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements, some of the specific objectives management may wish to consider include the following:

- Transactions are executed in accordance with management's general or specific authorization.
- Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- Access to assets is permitted only in accordance with management's authorization.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

#### Access to Assets

3. The objectives of safeguarding assets requires that access to assets be limited to authorized personnel. In this context, access to assets includes both direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of assets. Access to assets is required in the normal operations of a business and, therefore, limiting access to authorized personnel is the maximum feasible constraint. The number and competence of personnel to whom access is authorized should be influenced by the nature of the assets and the related susceptibility to loss through errors and irregularities. Limitation of direct access to assets requires appropriate physical segregation and protective equipment or devices.

#### Comparison of Recorded Accountability With Assets

4. The purpose of comparing recorded accountability with assets is to determine whether the actual assets agree with the recorded accountability. Typical examples of this comparison include cash and securities counts, bank reconciliations, and physical inventories.

5. If the comparison reveals that the assets do not agree with the recorded accountability, it provides evidence of unrecorded or improperly recorded

transactions. The converse, however, does not necessarily follow. For example, agreement of cash count with the recorded balance does not provide evidence that all cash received has been properly recorded.

6. This illustrates an unavoidable distinction between fiduciary and recorded accountability: the former arises immediately upon acquisition of an asset; the latter arises only when the initial record of the transaction is prepared.

7. As to assets that are susceptible to loss through errors or irregularities, the comparison with recorded accountability should be made independently. The frequency with which such comparison should be made for the purpose of safeguarding assets depends on the nature and amount of the assets involved and the cost of making the comparison. For example, it may be reasonable to count cash daily but not reasonable to take a physical inventory at that interval. However, a daily inventory of products in the custody of route salesmen, for example, may be practicable as a means of determining their accountability for sales. Similarly, the value and vulnerability of some products may make frequent complete inventories worthwhile.

8. The frequency with which comparison of recorded accountability with assets should be made for the purpose of achieving reliability of the records for preparing financial statements depends on the materiality of the assets and their susceptibility to loss through errors and irregularities.

9. The action that may be appropriate with respect to any discrepancies revealed by the comparison of recorded accountability with assets will depend primarily on the nature of the asset, the system in use, and the amount and cause of the discrepancy. Appropriate action may include adjustment of the accounting records, filing of insurance claims, revision of procedures, or administrative action to improve the performance of personnel.

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[The next page is 307.]



## AU Section 322

# ***The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements***

(Supersedes SAS No. 9)

Source: SAS No. 65

Effective for audits of financial statements for periods ending after December 15, 1991, unless otherwise indicated.

.01 The auditor considers many factors in determining the nature, timing, and extent of auditing procedures to be performed in an audit of an entity's financial statements. One of the factors is the existence of an internal audit function.<sup>1</sup> This section provides the auditor with guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor in an audit performed in accordance with generally accepted auditing standards.

### **Roles of the Auditor and the Internal Auditors**

.02 One of the auditor's responsibilities in an audit conducted in accordance with generally accepted auditing standards is to obtain sufficient competent evidential matter to provide a reasonable basis for the opinion on the entity's financial statements. In fulfilling this responsibility, the auditor maintains independence from the entity.<sup>2</sup>

.03 Internal auditors are responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity's management and board of directors or to others with equivalent authority and responsibility. To fulfill this responsibility, internal auditors maintain objectivity with respect to the activity being audited.

### **Obtaining an Understanding of the Internal Audit Function**

.04 An important responsibility of the internal audit function is to monitor the performance of an entity's controls. When obtaining an understanding of the internal control structure,<sup>3</sup> the auditor should obtain an understanding of the internal audit function sufficient to identify those

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<sup>1</sup> An *internal audit function* may consist of one or more individuals who perform internal auditing activities within an entity. This section is not applicable to personnel who have the title *internal auditor* but who do not perform internal auditing activities as described herein.

<sup>2</sup> Although internal auditors are not independent from the entity, The Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* defines internal auditing as an independent appraisal function and requires internal auditors to be independent of the activities they audit. This concept of independence is different from the independence the auditor maintains under the AICPA Code of Professional Conduct.

<sup>3</sup> Section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*, describes the procedures the auditor follows to obtain an understanding of the internal control structure and indicates that the internal audit function is part of the entity's control environment.

internal audit activities that are relevant to planning the audit. The extent of the procedures necessary to obtain this understanding will vary, depending on the nature of those activities.

**.05** The auditor ordinarily should make inquiries of appropriate management and internal audit personnel about the internal auditors'—

- a. Organizational status within the entity.
- b. Application of professional standards (see paragraph .11).
- c. Audit plan, including the nature, timing, and extent of audit work.
- d. Access to records and whether there are limitations on the scope of their activities.

In addition, the auditor might inquire about the internal audit function's charter, mission statement, or similar directive from management or the board of directors. This inquiry will normally provide information about the goals and objectives established for the internal audit function.

**.06** Certain internal audit activities may not be relevant to an audit of the entity's financial statements. For example, the internal auditors' procedures to evaluate the efficiency of certain management decision-making processes are ordinarily not relevant to a financial statement audit.

**.07** Relevant activities are those that provide evidence about the design and effectiveness of internal control structure policies and procedures that pertain to the entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the financial statements or that provide direct evidence about potential misstatements of such data. The auditor may find the results of the following procedures helpful in assessing the relevancy of internal audit activities:

- a. Considering knowledge from prior-year audits
- b. Reviewing how the internal auditors allocate their audit resources to financial or operating areas in response to their risk-assessment process
- c. Reading internal audit reports to obtain detailed information about the scope of internal audit activities

**.08** If, after obtaining an understanding of the internal audit function, the auditor concludes that the internal auditors' activities are not relevant to the financial statement audit, the auditor does not have to give further consideration to the internal audit function unless the auditor requests direct assistance from the internal auditors as described in paragraph .27. Even if some of the internal auditors' activities are relevant to the audit, the auditor may conclude that it would not be efficient to consider further the work of the internal auditors. If the auditor decides that it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of audit procedures, the auditor should assess the competence and objectivity of the internal audit function in light of the intended effect of the internal auditors' work on the audit.

## **Assessing the Competence and Objectivity of the Internal Auditors**

### **Competence of the Internal Auditors**

**.09** When assessing the internal auditors' competence, the auditor should obtain or update information from prior years about such factors as—

- Educational level and professional experience of internal auditors.

- Professional certification and continuing education.
- Audit policies, programs, and procedures.
- Practices regarding assignment of internal auditors.
- Supervision and review of internal auditors' activities.
- Quality of working-paper documentation, reports, and recommendations.
- Evaluation of internal auditors' performance.

### Objectivity of the Internal Auditors

.10 When assessing the internal auditors' objectivity, the auditor should obtain or update information from prior years about such factors as—

- The organizational status of the internal auditor responsible for the internal audit function, including—
  - Whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors.
  - Whether the internal auditor has direct access and reports regularly to the board of directors, the audit committee, or the owner-manager.
  - Whether the board of directors, the audit committee, or the owner-manager oversees employment decisions related to the internal auditor.
- Policies to maintain internal auditors' objectivity about the areas audited, including—
  - Policies prohibiting internal auditors from auditing areas where relatives are employed in important or audit-sensitive positions.
  - Policies prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the internal audit function.

### Assessing Competence and Objectivity

.11 In assessing competence and objectivity, the auditor usually considers information obtained from previous experience with the internal audit function, from discussions with management personnel, and from a recent external quality review, if performed, of the internal audit function's activities. The auditor may also use professional internal auditing standards<sup>4</sup> as criteria in making the assessment. The auditor also considers the need to test the effectiveness of the factors described in paragraphs .09 and .10. The extent of such testing will vary in light of the intended effect of the internal auditors' work on the audit. If the auditor determines that the internal auditors are sufficiently competent and objective, the auditor should then consider how the internal auditors' work may affect the audit.

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<sup>4</sup> Standards have been developed for the professional practice of internal auditing by The Institute of Internal Auditors and the General Accounting Office. These standards are meant to (a) impart an understanding of the role and responsibilities of internal auditing to all levels of management, boards of directors, public bodies, external auditors, and related professional organizations; (b) permit measurement of internal auditing performance; and (c) improve the practice of internal auditing.

## Effect of the Internal Auditors' Work on the Audit

.12 The internal auditors' work may affect the nature, timing, and extent of the audit, including—

- Procedures the auditor performs when obtaining a understanding of the entity's internal control structure (paragraph .13).
- Procedures the auditor performs when assessing risk (paragraphs .14 through .16).
- Substantive procedures the auditor performs (paragraph .17).

When the work of internal auditors is expected to affect the audit, the guidance in paragraphs .18 through .26 should be followed for considering the extent of the effect, coordinating audit work with internal auditors, and evaluating and testing the effectiveness of internal auditors' work.

## Understanding of the Internal Control Structure

.13 The auditor obtains a sufficient understanding of the design of internal control structure policies and procedures to plan the audit and to determine whether they have been placed in operation. Since a primary objective of many internal audit functions is to review, assess, and monitor internal control structure policies and procedures, the procedures performed by the internal auditors in this area may provide useful information to the auditor. For example, internal auditors may develop a flowchart of a new computerized sales and receivables system. The auditor may review the flowchart to obtain information about the design of the related policies and procedures. In addition, the auditor may consider the results of procedures performed by the internal auditors on related policies and procedures to obtain information about whether the policies and procedures have been placed in operation.

## Risk Assessment

.14 The auditor assesses the risk of material misstatement at both the financial-statement level and the account-balance or class-of-transaction level.

### Financial-Statement Level

.15 At the financial-statement level, the auditor makes an overall assessment of the risk of material misstatement. When making this assessment, the auditor should recognize that certain internal control structure policies and procedures may have a pervasive effect on many financial statement assertions. The control environment and accounting system often have a pervasive effect on a number of account balances and transaction classes and therefore can affect many assertions. The auditor's assessment of risk at the financial-statement level often affects the overall audit strategy. The entity's internal audit function may influence this overall assessment of risk as well as the auditor's resulting decisions concerning the nature, timing, and extent of auditing procedures to be performed. For example, if the internal auditors' plan includes relevant audit work at various locations, the auditor may coordinate work with the internal auditors (see paragraph .23) and reduce the number of the entity's locations at which the auditor would otherwise need to perform auditing procedures.

### Account-Balance or Class-of-Transaction Level

.16 At the account-balance or class-of-transaction level, the auditor performs procedures to obtain and evaluate evidential matter concerning management's assertions. The auditor assesses control risk for each of the

significant assertions and performs tests of controls to support assessments below the maximum. When planning and performing tests of controls, the auditor may consider the results of procedures planned or performed by the internal auditors. For example, the internal auditors' scope may include tests of controls for the completeness of accounts payable. The results of internal auditors' tests may provide appropriate information about the effectiveness of internal control structure policies and procedures and change the nature, timing, and extent of testing the auditor would otherwise need to perform.

### Substantive Procedures

.17 Some procedures performed by the internal auditors may provide direct evidence about material misstatements in assertions about specific account balances or classes of transactions. For example, the internal auditors, as part of their work, may confirm certain accounts receivable and observe certain physical inventories. The results of these procedures can provide evidence the auditor may consider in restricting detection risk for the related assertions. Consequently, the auditor may be able to change the timing of the confirmation procedures, the number of accounts receivable to be confirmed, or the number of locations of physical inventories to be observed.

### Extent of the Effect of the Internal Auditors' Work

.18 Even though the internal auditors' work may affect the auditor's procedures, the auditor should perform procedures to obtain sufficient, competent, evidential matter to support the auditor's report. Evidence obtained through the auditor's direct personal knowledge, including physical examination, observation, computation, and inspection, is generally more persuasive than information obtained indirectly.<sup>5</sup>

.19 The responsibility to report on the financial statements rests solely with the auditor. Unlike the situation in which the auditor uses the work of other independent auditors,<sup>6</sup> this responsibility cannot be shared with the internal auditors. Because the auditor has the ultimate responsibility to express an opinion on the financial statements, judgments about assessments of inherent and control risks, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the auditor.

.20 In making judgments about the extent of the effect of the internal auditors' work on the auditor's procedures, the auditor considers—

- a. The materiality of financial statement amounts—that is, account balances or classes of transactions.
- b. The risk (consisting of inherent risk and control risk) of material misstatement of the assertions related to these financial statement amounts.
- c. The degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the assertions.<sup>7</sup>

As the materiality of the financial statement amounts increases and either the risk of material misstatement or the degree of subjectivity increases, the need for the auditor to perform his or her own tests of the assertions increases. As

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<sup>5</sup> See section 326, *Evidential Matter*, paragraph 19c.

<sup>6</sup> See section 543, *Part of Audit Performed by Other Independent Auditors*.

<sup>7</sup> For some assertions, such as existence and occurrence, the evaluation of audit evidence is generally objective. More subjective evaluation of the audit evidence is often required for other assertions, such as the valuation and disclosure assertions.

these factors decrease, the need for the auditor to perform his or her own tests of the assertions decreases.

.21 For assertions related to material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill the responsibilities described in paragraphs .18 and .19. In determining these procedures, the auditor gives consideration to the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions. However, for such assertions, the consideration of internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions directly by the auditor. Assertions about the valuation of assets and liabilities involving significant accounting estimates, and about the existence and disclosure of related-party transactions, contingencies, uncertainties, and subsequent events, are examples of assertions that might have a high risk of material misstatement or involve a high degree of subjectivity in the evaluation of audit evidence.

.22 On the other hand, for certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions, that audit risk has been reduced to an acceptable level and that testing of the assertions directly by the auditor may not be necessary. Assertions about the existence of cash, prepaid assets, and fixed-asset additions are examples of assertions that might have a low risk of material misstatement or involve a low degree of subjectivity in the evaluation of audit evidence.

## **Coordination of the Audit Work With Internal Auditors**

.23 If the work of the internal auditors is expected to have an effect on the auditor's procedures, it may be efficient for the auditor and the internal auditors to coordinate their work by—

- Holding periodic meetings.
- Scheduling audit work.
- Providing access to internal auditors' working papers.
- Reviewing audit reports.
- Discussing possible accounting and auditing issues.

## **Evaluating and Testing the Effectiveness of Internal Auditors' Work**

.24 The auditor should perform procedures to evaluate the quality and effectiveness of the internal auditors' work, as described in paragraphs .12 through .17, that significantly affects the nature, timing, and extent of the auditor's procedures. The nature and extent of the procedures the auditor should perform when making this evaluation are a matter of judgment depending on the extent of the effect of the internal auditors' work on the auditor's procedures for significant account balances or classes of transactions.

.25 In developing the evaluation procedures, the auditor should consider such factors as whether the internal auditors'—

- Scope of work is appropriate to meet the objectives.
- Audit programs are adequate.

- Working papers adequately document work performed, including evidence of supervision and review.
- Conclusions are appropriate in the circumstances.
- Reports are consistent with the results of the work performed.

.26 In making the evaluation, the auditor should test some of the internal auditors' work related to the significant financial statement assertions. These tests may be accomplished by either (a) examining some of the controls, transactions, or balances that the internal auditors examined or (b) examining similar controls, transactions, or balances not actually examined by the internal auditors. In reaching conclusions about the internal auditors' work, the auditor should compare the results of his or her tests with the results of the internal auditors' work. The extent of this testing will depend on the circumstances and should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the internal audit work being considered by the auditor.

## Using Internal Auditors to Provide Direct Assistance to the Auditor

.27 In performing an audit, the auditor may request direct assistance from the internal auditors. This direct assistance relates to work the auditor specifically requests the internal auditors to perform to complete some aspect of the auditor's work. For example, internal auditors may assist the auditor in obtaining an understanding of the internal control structure or in performing tests of controls or substantive tests, consistent with the guidance about the auditor's responsibility in paragraphs .18 through .22. When direct assistance is provided, the auditor should assess the internal auditors' competence and objectivity (see paragraphs .09 through .11) and supervise,<sup>8</sup> review, evaluate, and test the work performed by internal auditors to the extent appropriate in the circumstances. The auditor should inform the internal auditors of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing and extent of audit procedures, such as possible accounting and auditing issues. The auditor should also inform the internal auditors that all significant accounting and auditing issues identified during the audit should be brought to the auditor's attention.

## Effective Date

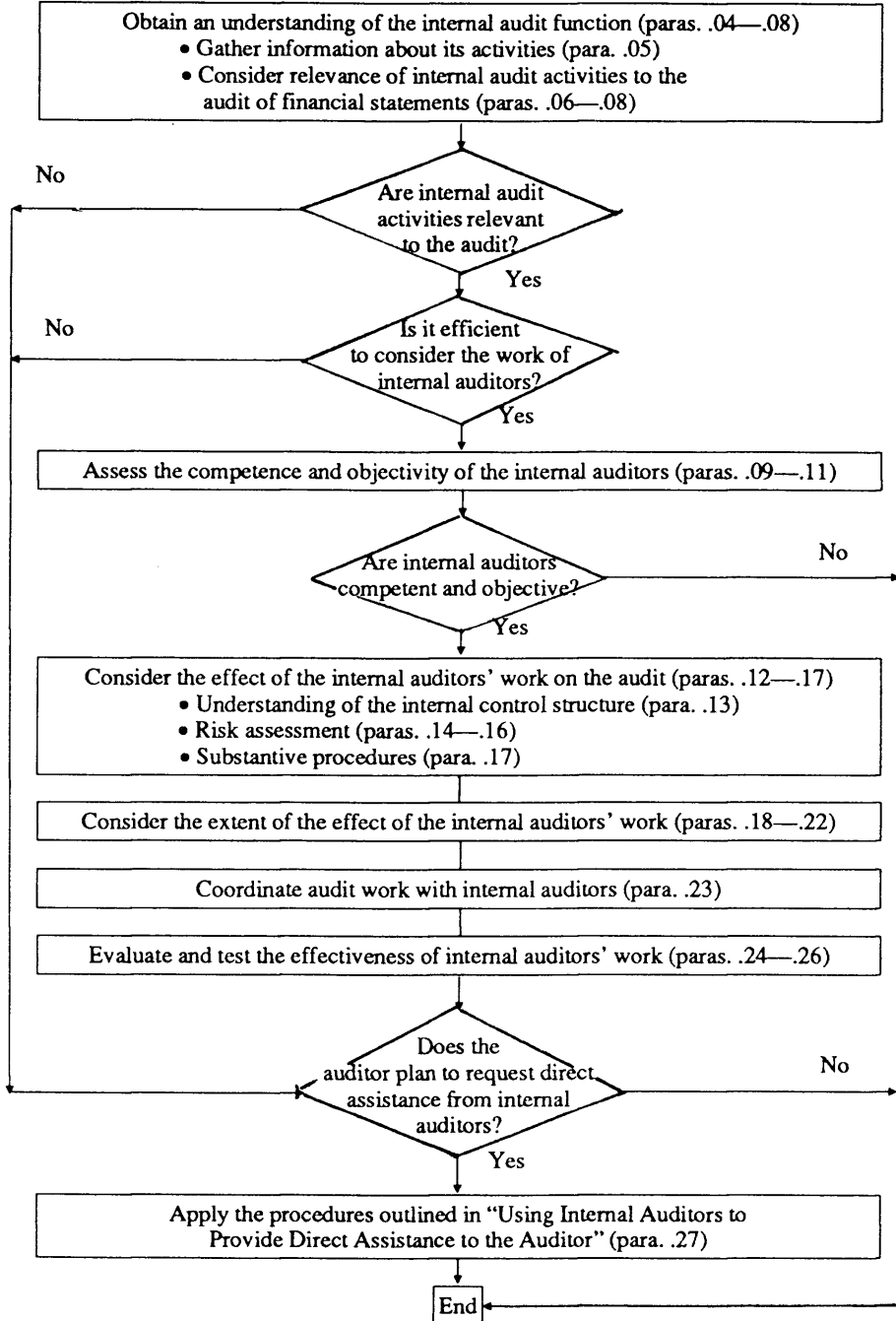
.28 This section is effective for audits of financial statements for periods ending after December 15, 1991. Early application of the provisions of this section is permissible.

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<sup>8</sup> See section 311, *Planning and Supervision*, paragraphs .11 through .14, for the type of supervisory procedures to apply.

## Appendix

### .29 The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements



[The next page is 321-7.]



## AU Section 324

# ***Reports on the Processing of Transactions by Service Organizations***

(Supersedes SAS No. 44)

Source: SAS No. 70.

Effective for service auditors' reports dated after March 31, 1993, unless otherwise indicated. Earlier application is encouraged.

### **Introduction and Applicability**

.01 This section provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. This section also provides guidance for independent auditors who issue reports on the processing of transactions by a service organization for use by other auditors.

.02 For purposes of this section, the following definitions apply:

- *User organization*—The entity that has engaged a service organization and whose financial statements are being audited
- *User auditor*—The auditor who reports on the financial statements of the user organization
- *Service organization*—The entity (or segment of an entity) that provides services to the user organization
- *Service auditor*—The auditor who reports on the processing of transactions by a service organization
- *Report on policies and procedures placed in operation*—A service auditor's report on a service organization's description of its control structure policies and procedures that may be relevant to a user organization's internal control structure, on whether such policies and procedures were suitably designed to achieve specified control objectives, and on whether they had been placed in operation as of a specific date
- *Report on policies and procedures placed in operation and tests of operating effectiveness*—A service auditor's report on a service organization's description of its control structure policies and procedures that may be relevant to a user organization's internal control structure,<sup>1</sup> on whether such policies and procedures were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the policies and procedures that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assur-

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<sup>1</sup> In this section, a service organization's control structure policies and procedures that may be relevant to a user organization's internal control structure will be referred to as a service organization's *policies and procedures*.

ance that the related control objectives were achieved during the period specified.

.03 The guidance in this section is applicable to the audit of the financial statements of an entity that obtains either or both of the following services from another organization:

- Executing transactions and maintaining the related accountability
- Recording transactions and processing related data

Service organizations that provide such services include, for example, bank trust departments that invest and hold assets for employee benefit plans or for others, mortgage bankers that service mortgages for others, and electronic data processing (EDP) service centers that process transactions and related data for others. The guidance in this section may also be relevant to situations in which an organization develops, provides, and maintains the software used by client organizations. The provisions of this section are not intended to apply to situations in which the services provided are limited to executing client organization transactions that are specifically authorized by the client, such as the processing of checking account transactions by a bank or the execution of securities transactions by a broker. This section also is not intended to apply to the audit of transactions arising from financial interests in partnerships, corporations, and joint ventures, such as working interests in oil and gas ventures, when proprietary interests are accounted for and reported to interest holders.

.04 This section is organized into the following sections:

- a. The user auditor's consideration of the effect of the service organization on the internal control structure of the user organization and the availability of evidence to—
  - Obtain the necessary understanding of the user organization's internal control structure to plan the audit
  - Assess control risk at the user organization
  - Perform substantive procedures
- b. Considerations in using a service auditor's report
- c. Responsibilities of service auditors

## **The User Auditor's Consideration of the Effect of the Service Organization on the Internal Control Structure of the User Organization and the Availability of Audit Evidence**

.05 The user auditor should consider the discussion in paragraphs .06 through .21 when planning and performing the audit of an entity that uses a service organization to process its transactions.

### **The Effect of a Service Organization on a User Organization's Internal Control Structure**

.06 When a user organization uses a service organization, transactions that affect the user organization's financial statements are subjected to policies and procedures that are, at least in part, physically and operationally separate from the user organization. The relationship of the policies and procedures of the service organization to those of the user organization depends primarily on the nature of the services provided by the service organization. For example, when those services are limited to recording user

transactions and processing the related data, and the user organization retains responsibility for authorizing transactions and maintaining the related accountability, there is a high degree of interaction between the policies and procedures at the service organization and those at the user organization. In these circumstances, it may be possible for the user organization to implement effective internal control structure policies and procedures for those transactions. When the service organization executes the user organization's transactions and maintains the related accountability, there is a lower degree of interaction and it may not be practicable for the user organization to implement effective internal control structure policies and procedures for those transactions. The degree of interaction, as well as the nature and materiality of the transactions processed by the service organization, are the most important factors in determining the significance of the service organization's policies and procedures to the user organization's internal control structure.

### Planning the Audit

.07 Section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*, states that an auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure to plan the audit. This understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to—

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

.08 If an entity uses a service organization, certain policies, procedures, and records of the service organization may be relevant to the user organization's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the entity's financial statements. In determining the significance of these policies, procedures, and records to planning the audit, the user auditor should consider factors such as—

- The significance of the financial statement assertions that are affected by the policies and procedures of the service organization.
- The inherent risk associated with the assertions affected by the policies and procedures of the service organization.
- The nature of the services provided by the service organization and whether they are highly standardized and used extensively by many user organizations or unique and used only by a few.
- The extent to which the user organization's internal control structure policies and procedures interact with the policies and procedures of the service organization.
- The user organization's internal control structure policies and procedures that are applied to the transactions affected by the service organization's activities.
- The terms of the contract between the user organization and the service organization (for example, their respective responsibilities and the extent of the service organization's discretion to initiate transactions).
- The service organization's capabilities, including it—
  - Record of performance.
  - Insurance coverage.

— Financial stability.

- The user auditor's prior experience with the service organization.
- The extent of auditable data in the user organization's possession.
- The existence of specific regulatory requirements that may dictate the application of audit procedures beyond those required to comply with generally accepted auditing standards.

.09 The user auditor should also consider the available information about the service organization's policies and procedures, including (a) the information in the user organization's possession, such as user manuals, system overviews, and technical manuals, and (b) the existence of reports on the service organization's policies and procedures, such as reports by service auditors, internal auditors (the user organization's or the service organization's), or regulatory authorities.

.10 After considering the above factors and evaluating the available information, the user auditor may conclude that he or she has the means to obtain a sufficient understanding of the internal control structure to plan the audit. If the user auditor concludes that information is not available to obtain a sufficient understanding to plan the audit, he or she may consider contacting the service organization, through the user organization, to obtain specific information or request that a service auditor be engaged to perform procedures that will supply the necessary information, or the user auditor may visit the service organization and perform such procedures. If the user auditor is unable to obtain sufficient evidence to achieve his or her audit objectives, the user auditor should qualify his or her opinion or disclaim an opinion on the financial statements because of a scope limitation.

### **Assessing Control Risk at the User Organization**

.11 After obtaining an understanding of the internal control structure, the user auditor assesses control risk for the assertions embodied in the account balances and classes of transactions, including those that are affected by the activities of the service organization. In doing so, the user auditor may identify certain internal control structure policies and procedures that, if effective, would permit the user auditor to assess control risk below the maximum for particular assertions. Such policies and procedures may be applied at either the user organization or the service organization. The user auditor may conclude that it would be efficient to obtain evidential matter about the operating effectiveness of these policies and procedures to provide a basis for assessing control risk below the maximum.

.12 A service auditor's report on policies and procedures placed in operation at the service organization should be helpful in providing a sufficient understanding to plan the audit of the user organization. Such a report, however, is not intended to provide any evidence of the operating effectiveness of the relevant policies and procedures that would allow the user auditor to reduce the assessed level of control risk below the maximum. Such evidential matter should be derived from one or more of the following:

- a. Tests of the user organization's controls over the activities of the service organization (for example, the user auditor may test the user organization's independent reperformance of selected items processed by an EDP service center or test the user organization's reconciliation of output reports with source documents)
- b. A service auditor's report on policies and procedures placed in operation and tests of operating effectiveness, or a report on the

application of agreed-upon procedures that describes relevant tests of controls

- c. Appropriate tests of controls performed by the user auditor at the service organization

.13 The user organization may establish effective controls over the service organization's activities that may be tested and that may enable the user auditor to reduce the assessed level of control risk below the maximum for some or all of the related assertions. If a user organization, for example, uses an EDP service center to process payroll transactions, the user organization may establish internal control structure policies and procedures over input and output data to prevent or detect material misstatements. The user organization might reperform the service organization's payroll calculations on a test basis. In this situation, the user auditor may perform tests of the user organization's controls over data processing that would provide a basis for assessing control risk below the maximum for the assertions related to payroll transactions. The user auditor may decide that obtaining evidence of the operating effectiveness of the service organization's policies and procedures, such as those over changes in payroll programs, is not necessary or efficient.

.14 The user auditor may find that internal control structure policies and procedures relevant to assessing control risk below the maximum for particular assertions are applied only at the service organization. If the user auditor plans to assess control risk below the maximum for those assertions, he or she should evaluate the operating effectiveness of those policies and procedures by obtaining a service auditor's report that describes the results of the service auditor's tests of those policies and procedures (that is, a report on policies and procedures placed in operation and tests of operating effectiveness, or an agreed-upon procedures report) or by performing tests of controls at the service organization. If the user auditor decides to use a service auditor's report, the user auditor should consider the extent of the evidence provided by the report about the effectiveness of policies and procedures intended to prevent or detect material misstatements in the particular assertions. The user auditor remains responsible for evaluating the evidence presented by the service auditor and for determining its effect on the assessment of control risk at the user organization.

.15 The user auditor's assessments of control risk regarding assertions about account balances or classes of transactions are based on the combined evidence provided by the service auditor's report and the user auditor's own procedures. In making these assessments, the user auditor should consider the nature, source, and interrelationships among the evidence, as well as the period covered by the tests of controls. The user auditor uses the assessed levels of control risk, as well as his or her understanding of the internal control structure, in determining the nature, timing, and extent of substantive tests for particular assertions.

.16 The guidance in section 319.46 through .55, regarding the auditor's consideration of the sufficiency of evidential matter to support a specific assessed level of control risk is applicable to user auditors considering evidential matter provided by a service auditor's report on policies and procedures placed in operation and tests of operating effectiveness. Because the report may be intended to satisfy the needs of several different user auditors, a user auditor should determine whether the specific tests of controls and results in the service auditor's report are relevant to assertions that are significant in the user organization's financial statements. For those tests of controls and results that are relevant, a user auditor should consider whether the nature, timing, and extent of such tests of controls and results provide appropriate evidence

about the effectiveness of the policy or procedure to support the user auditor's desired assessed level of control risk. In evaluating these factors, user auditors should also keep in mind that, for certain assertions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less support for control risk reduction the test may provide.

### **Audit Evidence From Substantive Audit Procedures Performed by Service Auditors**

.17 Service auditors may be engaged to perform procedures that are substantive in nature for the benefit of user auditors. Such engagements may involve the performance, by the service auditor, of procedures agreed upon by the user organization and its auditor and by the service organization and its auditor. In addition, there may be requirements imposed by governmental authorities or through contractual arrangements whereby service auditors perform designated procedures that are substantive in nature. The results of the application of the required procedures to balances and transactions processed by the service organization may be used by user auditors as part of the evidence necessary to support their opinions.

### **Considerations in Using a Service Auditor's Report**

.18 In considering whether the service auditor's report is satisfactory for his or her purposes, the user auditor should make inquiries concerning the service auditor's professional reputation. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in section 543, *Part of Audit Performed by Other Independent Auditors*, paragraph .10a.

.19 In considering whether the service auditor's report is sufficient to meet his or her objectives, the user auditor should give consideration to the guidance in section 543.12. If the user auditor believes that the service auditor's report may not be sufficient to meet his or her objectives, the user auditor may supplement his or her understanding of the service auditor's procedures and conclusions by discussing with the service auditor the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, he or she may contact the service organization, through the user organization, to request that the service auditor perform agreed-upon procedures at the service organization, or the user auditor may perform such procedures.

.20 When assessing a service organization's policies and procedures and how they interact with a user organization's internal control structure policies and procedures, the user auditor may become aware of the existence of reportable conditions. In such circumstances, the user auditor should consider the guidance provided in section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit*.

.21 The user auditor should not make reference to the report of the service auditor as a basis, in part, for his or her own opinion on the user organization's financial statements. The service auditor's report is used in the audit, but the service auditor is not responsible for examining any portion of the financial statements as of any specific date or for any specified period. Thus, there cannot be a division of responsibility for the audit of the financial statements.

## Responsibilities of Service Auditors

.22 The service auditor is responsible for the representations in his or her report and for exercising due care in the application of procedures that support those representations. Although a service auditor's engagement differs from an audit of financial statements conducted in accordance with generally accepted auditing standards, it should be performed in accordance with the general standards and with the relevant fieldwork and reporting standards. Although the service auditor should be independent from the service organization, it is not necessary for the service auditor to be independent from each user organization.

.23 As a result of procedures performed at the service organization, the service auditor may become aware of illegal acts, irregularities, or uncorrected errors attributable to the service organization's management or employees that may affect one or more user organizations. The terms *errors*, *irregularities*, and *illegal acts* are defined in section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and section 317, *Illegal Acts by Clients*; the definitions therein are relevant to this section. When the service auditor becomes aware of such matters, he or she should determine from the appropriate level of management of the service organization whether this information has been communicated appropriately to affected user organizations, unless those matters are clearly inconsequential. If the management of the service organization has not communicated the information to affected user organizations and is unwilling to do so, the service auditor should inform the service organization's audit committee or others with equivalent authority or responsibility. If the audit committee does not respond appropriately to the service auditor's communication, the service auditor should consider whether to resign from the engagement. The service auditor may wish to consult with his or her attorney in making this decision.

.24 The type of engagement to be performed and the related report to be prepared should be established by the service organization. However, when circumstances permit, discussions between the service organization and the user organizations are advisable to determine the type of report that will be most suitable for the user organizations' needs. This section provides guidance on the two types of reports that may be issued:

- a. *Reports on policies and procedures placed in operation*—A service auditor's report on a service organization's description of the policies and procedures that may be relevant to a user organization's internal control structure, on whether such policies and procedures were suitably designed to achieve specified control objectives, and on whether they had been placed in operation as of a specific date. Such reports may be useful in providing a user auditor with an understanding of the policies and procedures necessary to plan the audit and to design effective tests of controls and substantive tests at the user organization, but they are not intended to provide the user auditor with a basis for reducing his or her assessments of control risk below the maximum.
- b. *Reports on policies and procedures placed in operation and tests of operating effectiveness*—A service auditor's report on a service organization's description of the policies and procedures that may be relevant to a user organization's internal control structure, on whether such policies and procedures were suitably designed to achieve specified control objectives, on whether they had been

placed in operation as of a specific date, and on whether the policies and procedures that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified. Such reports may be useful in providing the user auditor with an understanding of the policies and procedures necessary to plan the audit and may also provide the user auditor with a basis for reducing his or her assessments of control risk below the maximum.

### **Reports on Policies and Procedures Placed in Operation**

**.25** The information necessary for a report on policies and procedures placed in operation ordinarily is obtained through discussions with appropriate service organization personnel and through reference to various forms of documentation, such as system flowcharts and narratives.

**.26** After obtaining a description of the relevant policies and procedures, the service auditor should determine whether the description provides sufficient information for user auditors to obtain an understanding of those aspects of the service organization's policies and procedures that may be relevant to a user organization's internal control structure. The description should contain a discussion of the features of the service organization's policies and procedures that would have an effect on a user organization's internal control structure. Such features are relevant when they directly affect the service provided to the user organization. They may include features generally considered to be part of the control environment, specific activities that may represent a user organization's accounting system or a portion thereof, or specific policies and procedures designed to control such functions. Control environment elements may include hiring practices and the involvement of internal auditors. Accounting system elements would include the ways in which user transactions are initiated and processed. Control structure policies and procedures employed by a service organization, such as policies and procedures over the modification of computer programs, ordinarily are designed to meet specific control objectives. The specific control objectives of the service organization should be set forth in the service organization's description of policies and procedures.

**.27** Evidence of whether policies and procedures have been placed in operation is ordinarily obtained through previous experience with the service organization and through procedures such as inquiry of appropriate management, supervisory, and staff personnel; inspection of service organization documents and records; and observation of service organization activities and operations. For the type of report described in paragraph .24a, these procedures need not be supplemented by tests of the operating effectiveness of the service organization's policies and procedures.

**.28** Although a service auditor's report on policies and procedures placed in operation is as of a specified date, the service auditor should inquire about changes in the service organization's policies and procedures that may have occurred before the beginning of fieldwork. If the service auditor believes that the changes would be considered significant by user organizations and their auditors, those changes should be included in the description of the service organization's policies and procedures. If the service auditor concludes that the changes would be considered significant by user organizations and their auditors and the changes are not included in the description of the service organization's policies and procedures, the service auditor should describe the changes in his or her report. Such changes might include—



- Procedural changes made to accommodate provisions of a new FASB Statement of Financial Accounting Standards.
- Major changes in an application to permit on-line processing.
- Procedural changes to eliminate previously identified deficiencies.

Changes that occurred more than twelve months before the date being reported on normally would not be considered significant, because they generally would not affect user auditors' considerations.

**.29** A service auditor's report expressing an opinion on a description of policies and procedures placed in operation at a service organization should contain—

- a. A specific reference to the applications, services, products, or other aspects of the service organization covered.
- b. A description of the scope and nature of the service auditor's procedures.
- c. Identification of the party specifying the control objectives.
- d. An indication that the purpose of the service auditor's engagement was to obtain reasonable assurance about whether (1) the service organization's description presents fairly, in all material respects, the aspects of the service organization's policies and procedures that may be relevant to a user organization's internal control structure, (2) the policies and procedures were suitably designed to achieve specified control objectives, and (3) such policies and procedures had been placed in operation as of a specific date.
- e. A disclaimer of opinion on the operating effectiveness of the policies and procedures.
- f. The service auditor's opinion on whether the description presents fairly, in all material respects, the relevant aspects of the service organization's policies and procedures that had been placed in operation as of a specific date and whether, in the service auditor's opinion, the policies and procedures were suitably designed to provide reasonable assurance that the specified control objectives would be achieved if those policies and procedures were complied with satisfactorily.
- g. A statement of the inherent limitations of the potential effectiveness of policies and procedures at the service organization and of the risk of projecting to future periods any evaluation of the description.
- h. Identification of the parties for whom the report is intended.

**.30** If the service auditor believes that the description is inaccurate or insufficiently complete for user auditors, the service auditor's report should so state and should contain sufficient detail to provide user auditors with an appropriate understanding.

**.31** It may become evident to the service auditor, when considering the service organization's description of policies and procedures placed in operation, that the system was designed with the assumption that certain internal control structure policies and procedures would be implemented by the user organization. If the service auditor is aware of the need for such complementary user organization internal control structure policies and procedures, these should be delineated in the description of policies and procedures. If the application of internal control structure policies and procedures by user organizations is necessary to achieve the stated control objectives, the service

auditor's report should be modified to include the phrase "and user organizations applied the internal control structure policies and procedures contemplated in the design of the Service Organization's policies and procedures" following the words "complied with satisfactorily" in the scope and opinion paragraphs.

**.32** The service auditor should consider conditions that come to his or her attention that, in the service auditor's judgment, represent significant deficiencies in the design or operation of the service organization's policies and procedures that preclude the service auditor from obtaining reasonable assurance that specified control objectives would be achieved. The service auditor should also consider whether any other information, irrespective of specified control objectives, has come to his or her attention that causes him or her to conclude (a) that design deficiencies exist that could adversely affect the ability to record, process, summarize, or report financial data to user organizations without error, and (b) that user organizations would not generally be expected to have policies and procedures in place to mitigate such design deficiencies.

**.33** The description of policies and procedures and control objectives required for these reports may be prepared by the service organization. If the service auditor prepares the description of policies and procedures and control objectives, the representations in the description remain the responsibility of the service organization.

**.34** For the service auditor to express an opinion on whether the policies and procedures were suitably designed to achieve the specified control objectives, it is necessary that—

- a. The service organization identify and appropriately describe such control objectives and the relevant policies and procedures.
- b. The service auditor consider the linkage of the policies and procedures to the stated control objectives.
- c. The service auditor obtain sufficient evidence to reach an opinion.

**.35** The control objectives may be designated by the service organization or by outside parties such as regulatory authorities, a user group, or others. When the control objectives are not established by outside parties, the service auditor should be satisfied that the control objectives, as set forth by the service organization, are reasonable in the circumstances and consistent with the service organization's contractual obligations.

**.36** The service auditor's report should state whether the policies and procedures were suitably designed to achieve the specified control objectives. The report should not state whether they were suitably designed to achieve objectives beyond the specifically identified control objectives.

**.37** The service auditor's opinion on whether the policies and procedures were suitably designed to achieve the specified control objectives is not intended to provide evidence of operating effectiveness or to provide the user auditor with a basis for concluding that control risk may be assessed below the maximum.

**.38** The following is a sample report on policies and procedures placed in operation at a service organization. The report should have, as an attachment, a description of the service organization's policies and procedures that may be relevant to a user organization's internal control structure. This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

To XYZ Service Organization:

We have examined the accompanying description of the \_\_\_\_\_ application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's policies and procedures that may be relevant to a user organization's internal control structure, (2) the control structure policies and procedures included in the description were suitably designed to achieve the control objectives specified in the description, if those policies and procedures were complied with satisfactorily,<sup>2</sup> and (3) such policies and procedures had been placed in operation as of \_\_\_\_\_. The control objectives were specified by \_\_\_\_\_. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

We did not perform procedures to determine the operating effectiveness of policies and procedures for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization's policies and procedures, individually or in the aggregate.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's policies and procedures that had been placed in operation as of \_\_\_\_\_. Also, in our opinion, the policies and procedures, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described policies and procedures were complied with satisfactorily.

The description of policies and procedures at XYZ Service Organization is as of \_\_\_\_\_ and any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system in existence. The potential effectiveness of specific policies and procedures at the Service Organization is subject to inherent limitations and, accordingly, errors or irregularities may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

.39 If the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors, the service auditor should so state in an explanatory paragraph preceding the opinion paragraph. An example of such an explanatory paragraph follows:

The accompanying description states that XYZ Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on inquiries of staff personnel and inspections of activities, we determined that such procedures are employed in Applications A and B but are not required to access the system in Applications C and D.

In addition, the first sentence of the opinion paragraph would be modified to read as follows:

In our opinion, except for the matter referred to in the preceding paragraph, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organiza-

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<sup>2</sup> If the application of internal control structure policies and procedures by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the internal control structure policies and procedures contemplated in the design of XYZ Service Organization's policies and procedures" following the words "complied with satisfactorily" in the scope and opinion paragraphs.

tion's policies and procedures that had been placed in operation as of \_\_\_\_\_.

.40 If, after applying the criteria in paragraph .32, the service auditor concludes that there are significant deficiencies in the design or operation of the service organization's policies and procedures, the service auditor should report those conditions in an explanatory paragraph preceding the opinion paragraph. An example of an explanatory paragraph describing a significant deficiency in the design or operation of the service organization's policies and procedures follows:

As discussed in the accompanying description, from time to time the Service Organization makes changes in application programs to correct deficiencies or to enhance capabilities. The procedures followed in determining whether to make changes, in designing the changes, and in implementing them do not include review and approval by authorized individuals who are independent from those involved in making the changes. There are also no specified requirements to test such changes or provide test results to an authorized reviewer prior to implementing the changes.

In addition, the second sentence of the opinion paragraph would be modified to read as follows:

Also in our opinion, except for the deficiency referred to in the preceding paragraph, the policies and procedures, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described policies and procedures were complied with satisfactorily.

### **Reports on Policies and Procedures Placed in Operation and Tests of Operating Effectiveness**

*Paragraphs .41 through .56 repeat some of the information contained in paragraphs .25 through .40 to provide readers with a comprehensive, stand-alone presentation of the relevant considerations for each type of report.*

.41 The information necessary for a report on policies and procedures placed in operation and tests of operating effectiveness ordinarily is obtained through discussions with appropriate service organization personnel, through reference to various forms of documentation, such as system flowcharts and narratives, and through the performance of tests of controls. Evidence of whether policies and procedures have been placed in operation is ordinarily obtained through previous experience with the service organization and through procedures such as inquiry of appropriate management, supervisory, and staff personnel; inspection of service organization documents and records; and observation of service organization activities and operations. The service auditor applies tests of controls to determine whether specified policies and procedures are operating with sufficient effectiveness to achieve specified control objectives. Section 350, *Audit Sampling*, provides guidance on the application and evaluation of audit sampling in performing tests of controls.

.42 After obtaining a description of the relevant policies and procedures, the service auditor should determine whether the description provides sufficient information for user auditors to obtain an understanding of the aspects of the service organization's policies and procedures that may be relevant to a user organization's internal control structure. The description should contain a discussion of the features of the service organization's policies and procedures that would have an effect on a user organization's internal control structure. Such features are relevant when they directly affect the service provided to the user organization. They may include features generally considered to be part of the control environment, specific activities that may represent a user organization's accounting system or a portion thereof, or specific policies and

procedures designed to control such functions. Control environment elements may include hiring practices and the involvement of internal auditors. Accounting system elements would include the ways in which user transactions are initiated and processed. Control structure policies and procedures employed by a service organization, such as policies and procedures over the modification of computer programs, ordinarily are designed to meet specific control objectives. The specific control objectives of the service organization should be set forth in the service organization's description of policies and procedures.

**.43** The service auditor should inquire about changes in the service organization's policies and procedures that may have occurred before the beginning of fieldwork. If the service auditor believes the changes would be considered significant by user organizations and their auditors, those changes should be included in the description of the service organization's policies and procedures. If the service auditor concludes that the changes would be considered significant by user organizations and their auditors and the changes are not included in the description of the service organization's policies and procedures, the service auditor should describe the changes in his or her report. Such changes might include—

- Procedural changes made to accommodate provisions of a new FASB Statement of Financial Accounting Standards.
- Major changes in an application to permit on-line processing.
- Procedural changes to eliminate previously identified deficiencies.

Changes that occurred more than twelve months before the date being reported on normally would not be considered significant, because they generally would not affect user auditors' considerations.

**.44** A service auditor's report expressing an opinion on a description of policies and procedures placed in operation at a service organization and tests of operating effectiveness should contain—

- a. A specific reference to the applications, services, products, or other aspects of the service organization covered.
- b. A description of the scope and nature of the service auditor's procedures.
- c. Identification of the party specifying the control objectives.
- d. An indication that the purpose of the service auditor's engagement was to obtain reasonable assurance about whether (1) the service organization's description presents fairly, in all material respects, the aspects of the service organization's policies and procedures that may be relevant to a user organization's internal control structure, (2) the policies and procedures were suitably designed to achieve specified control objectives, and (3) such policies and procedures had been placed in operation as of a specific date.
- e. The service auditor's opinion on whether the description presents fairly, in all material respects, the relevant aspects of the service organization's policies and procedures that had been placed in operation as of a specific date and whether, in the service auditor's opinion, the policies and procedures were suitably designed to provide reasonable assurance that the specified control objectives would be achieved if those policies and procedures were complied with satisfactorily.

- f.* A reference to a description of tests of specified service organization policies and procedures designed to obtain evidence about the operating effectiveness of those policies and procedures in achieving specified control objectives. The description should include the policies and procedures that were tested, the control objectives the policies and procedures were intended to achieve, the tests applied, and the results of the tests. The description should include an indication of the nature, timing, and extent of the tests, as well as sufficient detail to enable user auditors to determine the effect of such tests on user auditors' assessments of control risk. To the extent that the service auditor identified causative factors for exceptions, determined the current status of corrective actions, or obtained other relevant qualitative information about exceptions noted, such information should be provided.
- g.* A statement of the period covered by the service auditor's report on the operating effectiveness of the specified policies and procedures.
- h.* The service auditor's opinion on whether the policies and procedures that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.
- i.* When all of the control objectives listed in the description of policies and procedures placed in operation are not covered by tests of operating effectiveness, a statement that the service auditor does not express an opinion on control objectives not listed in the description of tests performed at the service organization.
- j.* A statement that the relative effectiveness and significance of specific service organization policies and procedures and their effect on assessments of control risk at user organizations are dependent on their interaction with the policies, procedures, and other factors present at individual user organizations.
- k.* A statement that the service auditor has performed no procedures to evaluate the effectiveness of policies and procedures at individual user organizations.
- l.* A statement of the inherent limitations of the potential effectiveness of policies and procedures at the service organization and of the risk of projecting to the future any evaluation of the description or any conclusions about the effectiveness of policies and procedures in achieving control objectives.
- m.* Identification of the parties for whom the report is intended.

**.45** If the service auditor believes that the description is inaccurate or insufficiently complete for user auditors, the service auditor's report should so state and should contain sufficient detail to provide user auditors with an appropriate understanding.

**.46** It may become evident to the service auditor, when considering the service organization's description of policies and procedures placed in operation, that the system was designed with the assumption that certain internal control structure policies and procedures would be implemented by the user organization. If the service auditor is aware of the need for such complementary user organization internal control structure policies and procedures, these should be delineated in the description of policies and procedures. If the

application of internal control structure policies and procedures by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the internal control structure policies and procedures contemplated in the design of the Service Organization's policies and procedures" following the words "complied with satisfactorily" in the scope and opinion paragraphs. Similarly, if the operating effectiveness of policies and procedures at the service organization is dependent on the application of policies and procedures at user organizations, this should be delineated in the description of tests performed.

**.47** The service auditor should consider conditions that come to his or her attention that, in the service auditor's judgment, represent significant deficiencies in the design or operation of the service organization's policies and procedures that preclude the service auditor from obtaining reasonable assurance that specified control objectives would be achieved. The service auditor should also consider whether any other information, irrespective of specified control objectives, has come to his or her attention that causes him or her to conclude (a) that design deficiencies exist that could adversely affect the ability to record, process, summarize, or report financial data to user organizations without error, and (b) that user organizations would not generally be expected to have policies and procedures in place to mitigate such design deficiencies.

**.48** The description of policies and procedures and control objectives required for these reports may be prepared by the service organization. If the service auditor prepares the description of policies and procedures and control objectives, the representations in the description remain the responsibility of the service organization.

**.49** For the service auditor to express an opinion on whether the policies and procedures were suitably designed to achieve the specified control objectives, it is necessary that—

- a. The service organization identify and appropriately describe such control objectives and the relevant policies and procedures.
- b. The service auditor consider the linkage of the policies and procedures to the stated control objectives.
- c. The service auditor obtain sufficient evidence to reach an opinion.

**.50** The control objectives may be designated by the service organization or by outside parties such as regulatory authorities, a user group, or others. When the control objectives are not established by outside parties, the service auditor should be satisfied that the control objectives, as set forth by the service organization, are reasonable in the circumstances and consistent with the service organization's contractual obligations.

**.51** The service auditor's report should state whether the policies and procedures were suitably designed to achieve the specified control objectives. The report should not state whether they were suitably designed to achieve objectives beyond the specifically identified control objectives.

**.52** The service auditor's opinion on whether the policies and procedures were suitably designed to achieve the specified control objectives is not intended to provide evidence of operating effectiveness or to provide the user auditor with a basis for concluding that control risk may be assessed below the maximum. Evidence that may enable the user auditor to conclude that control risk may be assessed below the maximum may be obtained from the results of specific tests of operating effectiveness.

.53 The management of the service organization specifies whether all or selected applications and control objectives will be covered by the tests of operating effectiveness. The service auditor determines which policies and procedures are, in his or her judgment, necessary to achieve the control objectives specified by management. The service auditor then determines the nature, timing, and extent of the tests of controls needed to evaluate operating effectiveness. Testing should be applied to policies and procedures in effect throughout the period covered by the report. To be useful to user auditors, the report should ordinarily cover a minimum reporting period of six months.

.54 The following is a sample report on policies and procedures placed in operation at a service organization and tests of operating effectiveness. It should be assumed that the report has two attachments: (a) a description of the service organization's policies and procedures that may be relevant to a user organization's internal control structure and (b) a description of policies and procedures for which tests of operating effectiveness were performed, the control objectives the policies and procedures were intended to achieve, the tests applied, and the results of those tests. This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

To XYZ Service Organization:

We have examined the accompanying description of the \_\_\_\_\_ application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's policies and procedures that may be relevant to a user organization's internal control structure, (2) the control structure policies and procedures included in the description were suitably designed to achieve the control objectives specified in the description, if those policies and procedures were complied with satisfactorily,<sup>3</sup> and (3) such policies and procedures had been placed in operation as of \_\_\_\_\_. The control objectives were specified by \_\_\_\_\_. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's policies and procedures that had been placed in operation as of \_\_\_\_\_. Also, in our opinion, the policies and procedures, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described policies and procedures were complied with satisfactorily.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific policies and procedures, listed in Schedule X, to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from \_\_\_\_\_ to \_\_\_\_\_. The specific policies and procedures and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of XYZ Service Organization and to their auditors to be taken into consideration, along with information about the internal control structure at user organizations, when making assessments of control risk for user organizations. In our opinion the policies and procedures that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from \_\_\_\_\_ to \_\_\_\_\_. [However, the scope of our engagement did not include tests to determine whether control objectives not

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<sup>3</sup> If the application of internal control structure policies and procedures by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the internal control structure policies and procedures contemplated in the design of XYZ Service Organization's policies and procedures" following the words "complied with satisfactorily" in the scope and opinion paragraphs.



listed in Schedule X were achieved; accordingly, we express no opinion on the achievement of control objectives not included in Schedule X.]<sup>4</sup>

The relative effectiveness and significance of specific policies and procedures at XYZ Service Organization and their effect on assessments of control risk at user organizations are dependent on their interaction with the policies, procedures, and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of policies and procedures at individual user organizations.

The description of policies and procedures at XYZ Service Organization is as of \_\_\_\_, and information about tests of the operating effectiveness of specified policies and procedures covers the period from \_\_\_\_ to \_\_\_\_\_. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system in existence. The potential effectiveness of specified policies and procedures at the Service Organization is subject to inherent limitations and, accordingly, errors or irregularities may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

**.55** If the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors, the service auditor should so state in an explanatory paragraph preceding the opinion paragraph. An example of such an explanatory paragraph follows:

The accompanying description states that XYZ Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on inquiries of staff personnel and inspection of activities, we determined that such procedures are employed in Applications A and B but are not required to access the system in Applications C and D.

In addition, the first sentence of the opinion paragraph would be modified to read as follows:

In our opinion, except for the matter referred to in the preceding paragraph, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's policies and procedures that had been placed in operation as of \_\_\_\_\_.

**.56** If, after applying the criteria in paragraph .47, the service auditor concludes that there are significant deficiencies in the design or operation of the service organization's policies and procedures, the service auditor should report those conditions in an explanatory paragraph preceding the opinion paragraph. An example of an explanatory paragraph describing a significant deficiency in the design or operation of the service organization's policies and procedures follows:

As discussed in the accompanying description, from time to time the Service Organization makes changes in application programs to correct deficiencies or to enhance capabilities. The procedures followed in determining whether to make changes, in designing the changes, and in implementing them do not include review and approval by authorized individuals who are independent from those involved in making the changes. There are also no specified requirements to test such changes or provide test results to an authorized reviewer prior to implementing the changes.

In addition, the second sentence of the opinion paragraph would be modified to read as follows:

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<sup>4</sup> This sentence should be added when all of the control objectives listed in the description of policies and procedures placed in operation are not covered by the tests of operating effectiveness. This sentence would be omitted when all of the control objectives listed in the description of policies and procedures placed in operation are included in the tests of operating effectiveness.

Also in our opinion except for the deficiency referred to in the preceding paragraph, the policies and procedures, as described, are suitably designed to provide reasonable assurance that the related control objectives would be achieved if the described policies and procedures were complied with satisfactorily.

### **Written Representations of the Service Organization's Management**

.57 Regardless of the type of report issued, the service auditor should obtain written representations from the service organization's management that—

- Acknowledge management's responsibility for establishing and maintaining appropriate policies and procedures relating to the processing of transactions for user organizations.
- Acknowledge the appropriateness of the specified control objectives.
- State that the description of policies and procedures presents fairly, in all material respects, the aspects of the service organization's policies and procedures that may be relevant to a user organization's internal control structure.
- State that the policies and procedures, as described, had been placed in operation as of a specified date.
- State that management believes its policies and procedures were suitably designed to achieve the specified control objectives.
- State that management has disclosed to the service auditor any significant changes in policies and procedures that have occurred since the service organization's last examination.
- State that management has disclosed to the service auditor any illegal acts, irregularities, or uncorrected errors attributable to the service organization's management or employees that may affect one or more user organizations.
- State that management has disclosed to the service auditor all design deficiencies in policies and procedures of which it is aware, including those for which management believes the cost of corrective action may exceed the benefits.

If the scope of the work includes tests of operating effectiveness, the service auditor should obtain a written representation from the service organization's management stating that management has disclosed to the service auditor all instances, of which it is aware, when policies and procedures have not operated with sufficient effectiveness to achieve the specified control objectives.

### **Reporting on Substantive Procedures**

.58 The service auditor may be requested to apply substantive procedures to user transactions or assets at the service organization. In such circumstances, the service auditor may make specific reference in his or her report to having carried out the designated procedures or may provide a separate report in accordance with section 622, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*. Either form of reporting should include a description of the nature, timing, extent, and results of the procedures in sufficient detail to be useful to user auditors in deciding whether to use the results as evidence to support their opinions.

### **Effective Date**

.59 This section is effective for service auditors' reports dated after March 31, 1993. Earlier application of this section is encouraged.

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[The next page is 321-29.]

**AU Section 325*****Communication of Internal Control Structure Related Matters Noted in an Audit***

(Supersedes AU sections 323 and 642.47—.53)

Source: SAS No. 60.

See section 9325 for interpretations of this section.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance in identifying and reporting conditions that relate to an entity's internal control structure observed during an audit of financial statements. It is contemplated that the communication would generally be to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor. For the purpose of this section, the term *audit committee* is used to refer to the appropriate recipient of the communication. This section also provides guidance on establishing, between the auditor and client, agreed-upon criteria for identifying and reporting additional matters beyond those required by this section.

**Reportable Conditions**

.02 During the course of an audit, the auditor may become aware of matters relating to the internal control structure that may be of interest to the audit committee. The matters that this section requires for reporting to the audit committee are referred to as *reportable conditions*.<sup>1</sup> Specifically, these are matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.<sup>2</sup> Such deficiencies may involve aspects of the internal control structure elements of (a) the control environment, (b) the accounting system, or (c) control procedures. (See paragraph .21, for examples of reportable conditions.)

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<sup>1</sup> This section supersedes section 323, *Required Communication of Material Weaknesses in Internal Accounting Control*, and section 642, *Reporting on Internal Accounting Control*, paragraphs .47 through .53, and related auditing interpretations. This section does not affect the reporting of material weaknesses noted in an engagement to report on an entity's internal control structure.

<sup>2</sup> The auditor should also consider matters coming to his attention that relate to interim financial reporting outside the entity in the communication contemplated by this section.

.03 The auditor may also identify matters that, in his judgment, are not reportable conditions as defined in paragraph .02; however, the auditor may choose to communicate such matters for the benefit of management (and other recipients, as appropriate).

## Identifying Reportable Conditions

.04 The auditor's objective in an audit of financial statements is to form an opinion on the entity's financial statements taken as a whole. The auditor is not obligated to search for reportable conditions. However, the auditor may become aware of possible reportable conditions through consideration of the elements of the internal control structure,<sup>3</sup> application of audit procedures to balances and transactions, or otherwise during the course of the audit. The auditor's awareness of reportable conditions varies with each audit and is influenced by the nature and extent of audit procedures and numerous other factors, such as an entity's size, its complexity, and the nature and diversity of its business activities.

.05 In making the judgment as to which matters are reportable conditions, the auditor should take into consideration various factors relating to the entity, such as its size, complexity and diversity of activities, organizational structure, and ownership characteristics.

.06 The existence of reportable conditions related to internal control structure design or operation may already be known and, in fact, may represent a conscious decision by management—a decision of which the audit committee is aware—to accept that degree of risk because of cost or other considerations. It is the responsibility of management to make the decisions concerning costs to be incurred and related benefits. Provided the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, the auditor may decide the matter does not need to be reported. Periodically, the auditor should consider whether, because of changes in management, the audit committee, or simply because of the passage of time, it is appropriate and timely to report such matters.

## Agreed-Upon Criteria

.07 The auditor and client may discuss the internal control structure and concerns regarding its functioning when making arrangements for the audit. Clients may request the auditor to be alert to matters and to report conditions that go beyond those contemplated by this section. The auditor is not precluded from reporting matters that he views to be of value to management in the absence of any specific request to do so.

.08 Agreed-upon arrangements between the auditor and the client to report conditions noted may include, for example, the reporting of matters of less significance than provided for by this section, the existence of conditions specified by the client, or the results of further investigation of matters noted to identify underlying causes. Under these arrangements, it is possible that the auditor may be requested to visit specific locations, assess specific control procedures, or undertake specific procedures not otherwise planned.

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<sup>3</sup> The *internal control structure* refers to the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. (See section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*, for additional key definitions.)

## Reporting—Form and Content

.09 Conditions noted by the auditor that are considered reportable under this section or that are the result of agreement with the client should be reported, preferably in writing. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers.

.10 The report should state that the communication is intended solely for the information and the use of the audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made.

.11 Any report issued on reportable conditions should—

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure.
- Include the definition of reportable conditions.
- Include the restriction on distribution as discussed in paragraph .10.

.12 The following is an illustration of the sections of a report encompassing the above requirements.

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

*[Include paragraphs to describe the reportable conditions noted.]*

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

.13 In some circumstances, the auditor may wish to include additional statements in the report regarding the inherent limitations of the internal control structure in general, the specific extent and nature of his consideration of the internal control structure during the audit, or other matters regarding the basis for the comments made.

.14 In a communication that contains both observations deemed by the auditor to be reportable conditions, as defined, and other comments, it may be appropriate to indicate which comments are in each category.

.15 A reportable condition may be of such magnitude as to be considered a material weakness. A *material weakness* in the internal control structure is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Although this section does not require that the

auditor separately identify and communicate material weaknesses, the auditor may choose or the client may request the auditor to separately identify and communicate as material weaknesses those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses. [As modified, June 1990, by the Audit Issues Task Force.]

.16 The following is an illustration of the sections of a report that may be used when the auditor wishes, or has been requested, to advise the audit committee in writing that one or more reportable conditions have been identified, but none is deemed to be a material weakness.

*[Include the first paragraph in the report illustrated in paragraph .12.]*

*[Include paragraphs to describe the reportable conditions noted.]*

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.

*[Include the final paragraph in the report illustrated in paragraph .12.]*

.17 Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no reportable conditions were noted during an audit, the auditor should not issue such representations.

.18 Because timely communication may be important, the auditor may choose to communicate significant matters during the course of the audit rather than after the audit is concluded. The decision on whether an interim communication should be issued would be influenced by the relative significance of the matters noted and the urgency of corrective follow-up action.

.19 The provisions in this section should not be viewed as precluding an auditor from communicating to a client a variety of observations and suggestions regarding its activities that go beyond internal control structure related matters. Such matters may deal with operational or administrative efficiencies, business strategies, and other items of perceived benefit to the client.

## **Effective Date**

.20 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989, with early application permissible.

## Appendix

### .21 Examples of Possible Reportable Conditions

1. As indicated in paragraph .02 of this section reportable conditions involve matters coming to the auditor's attention that relate to significant deficiencies in the design or operation of the internal control structure that, in the auditor's judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

2. The following are examples of matters that may be reportable conditions. They are grouped by categories of conditions and within categories by specific examples of conditions. Certain of these matters may also require communications under the provisions of other statements on auditing standards.

#### *Deficiencies in internal control structure design*

- Inadequate overall internal control structure design
- Absence of appropriate segregation of duties consistent with appropriate control objectives
- Absence of appropriate reviews and approvals of transactions, accounting entries, or systems output
- Inadequate procedures for appropriately assessing and applying accounting principles
- Inadequate provisions for the safeguarding of assets
- Absence of other control techniques considered appropriate for the type and level of transaction activity
- Evidence that a system fails to provide complete and accurate output that is consistent with objectives and current needs because of design flaws

#### *Failures in the operation of the internal control structure*

- Evidence of failure of identified controls in preventing or detecting misstatements of accounting information
- Evidence that a system fails to provide complete and accurate output consistent with the entity's control objectives because of the misapplication of control procedures
- Evidence of failure to safeguard assets from loss, damage or misappropriation
- Evidence of intentional override of the internal control structure by those in authority to the detriment of the overall objectives of the system
- Evidence of failure to perform tasks that are part of the internal control structure, such as reconciliations not prepared or not timely prepared
- Evidence of willful wrongdoing by employees or management
- Evidence of manipulation, falsification, or alteration of accounting records or supporting documents
- Evidence of intentional misapplication of accounting principles

- Evidence of misrepresentation by client personnel to the auditor
- Evidence that employees or management lack the qualifications and training to fulfill their assigned functions

*Others*

- Absence of a sufficient level of control consciousness within the organization
  - Failure to follow up and correct previously identified internal control structure deficiencies
  - Evidence of significant or extensive undisclosed related party transactions
  - Evidence of undue bias or lack of objectivity by those responsible for accounting decisions
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[The next page is 321-37.]



**AU Section 9325*****Communication of Internal Control Structure Related Matters Noted in an Audit: Auditing Interpretations of Section 325*****1. Reporting on the Existence of Material Weaknesses**

**.01 Question**—Section 325 requires the auditor to report to the audit committee or to individuals with equivalent authority and responsibility reportable conditions noted during an audit of financial statements. It permits the issuance of reports that include a statement about whether any of the reportable conditions identified are material weaknesses. In connection with an audit, may the auditor issue a written report on material weaknesses separate from the report on reportable conditions?

**.02 Interpretation**—Yes. Section 325 does not preclude the auditor from issuing a separate report stating whether he or she noted any material weaknesses during the audit. Reports on material weaknesses should—

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure.
- Include the definition of a material weakness.
- State that the communication is intended solely for the information and the use of the audit committee, management, and others within the organization. When there are requirements established by governmental agencies to furnish such reports, specific reference to such regulatory authorities may be made.

**.03** Section 325 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during the audit. Therefore, in issuing a report stating that no material weaknesses were noted, the auditor should not imply that no reportable conditions were noted.

**.04** The following is an illustration of a report encompassing the above requirements:

In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

.05 If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention. The last sentence of the first paragraph of the report should be modified as follows and paragraphs describing the material weaknesses should follow the first paragraph:

However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

.06 In some cases reports on material weaknesses may include comments on specific aspects of the internal control structure or on additional matters. For example, a regulatory agency may require comments on the accounting system and control procedures (but not on the control environment) or on compliance with certain provisions in contracts or regulations. In such cases the language in paragraph .04 should be modified to:

- a. identify clearly the specific aspects of the internal control structure or the additional matters covered by the report
- b. distinguish any additional matters from the internal control structure
- c. describe in reasonable detail the scope of the review and tests concerning the additional matters
- d. express conclusions in language comparable to that in paragraph .04 or .05, as appropriate

.07 The identification of the specific aspects of the internal control structure or additional matters covered in the report should be as specific as the auditor considers necessary to prevent misunderstanding in this respect. Such identification can be made in some cases by reference to specific portions of other documents such as contracts or regulations.

[Issue Date: February, 1989.]

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[The next page is 321-41.]

## AU Section 326

### ***Evidential Matter***

(Supersedes section 330, "Evidential Matter")

Sources: SAS No. 31; SAS No. 48.

See section 9326 for interpretations of this section.

Issue date, unless otherwise indicated: August, 1980.

.01 The third standard of field work is:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

.02 Most of the independent auditor's work in forming his opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he develops his opinion with respect to financial statements under audit. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

### **Nature of Assertions**

.03 Assertions are representations by management that are embodied in financial statement components. They can be either explicit or implicit and can be classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

.04 Assertions about existence or occurrence deal with whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period. For example, management asserts that finished goods inventories in the balance sheet are available for sale. Similarly, management asserts that sales in the income statement represent the exchange of goods or services with customers for cash or other consideration.

.05 Assertions about completeness deal with whether all transactions and accounts that should be presented in the financial statements are so included. For example, management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

**.06** Assertions about rights and obligations deal with whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. For example, management asserts that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property and that the corresponding lease liability represents an obligation of the entity.

**.07** Assertions about valuation or allocation deal with whether asset, liability, revenue, and expense components have been included in the financial statements at appropriate amounts. For example, management asserts that property is recorded at historical cost and that such cost is systematically allocated to appropriate accounting periods. Similarly, management asserts that trade accounts receivable included in the balance sheet are stated at net realizable value.

**.08** Assertions about presentation and disclosure deal with whether particular components of the financial statements are properly classified, described, and disclosed. For example, management asserts that obligations classified as long-term liabilities in the balance sheet will not mature within one year. Similarly, management asserts that amounts presented as extraordinary items in the income statement are properly classified and described.

## **Use of Assertions in Developing Audit Objectives and Designing Substantive Tests**

**.09** In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in the light of those assertions. In developing the audit objectives of a particular engagement, the auditor should consider the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry. For example, one audit objective related to the assertion about completeness that an auditor might develop for inventory balances is that inventory quantities include all products, materials, and supplies on hand.

**.10** There is not necessarily a one-to-one relationship between audit objectives and procedures. Some auditing procedures may relate to more than one objective. On the other hand, a combination of auditing procedures may be needed to achieve a single objective. Paragraph .48 provides illustrative audit objectives for inventories of a manufacturing company for each of the broad categories of assertions listed in paragraph .03 and examples of substantive tests that may achieve those audit objectives.

**.11** In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the risk of material misstatement of the financial statements, including the assessed levels of control risk, and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved. For example, in designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the auditor selects from items contained in a financial statement amount and searches for relevant evidential matter. On the other hand, in designing procedures to achieve an objective related to the assertion of completeness, the auditor selects from evidential matter indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included.

**.12** The auditor's specific audit objectives do not change whether accounting data is processed manually or by computer. However, the methods of

applying audit procedures to gather evidence may be influenced by the method of data processing. The auditor can use either manual audit procedures, computer-assisted audit techniques, or a combination of both to obtain sufficient, competent evidential matter. However, in some accounting systems that use a computer for processing significant accounting applications, it may be difficult or impossible for the auditor to obtain certain data for inspection, inquiry, or confirmation without computer assistance. [New paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.13 The nature, timing, and extent of the procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor, based on the specific circumstances. However, the procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of financial statements. The evidential matter provided by the combination of the auditor's assessment of inherent risk and control risk and on substantive tests should provide a reasonable basis for his opinion (see section 319.61—.64. .12 renumbered and reference changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.)

## **Nature of Evidential Matter**

.14 Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor. [Formerly paragraph .13, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.15 The books of original entry, the general and subsidiary ledgers, related accounting manuals, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations all constitute evidence in support of the financial statements. By itself, accounting data cannot be considered sufficient support for financial statements; on the other hand, without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on financial statements would not be warranted. [Formerly paragraph .14, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.16 Corroborating evidential matter includes documentary material such as checks, invoices, contracts, and minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor which permits him to reach conclusions through valid reasoning. [Formerly paragraph .15, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.17 The auditor tests underlying accounting data by analysis and review, by retracing the procedural steps followed in the accounting process and in developing the work sheets and allocations involved, by recalculation, and by reconciling related types and applications of the same information. In a soundly conceived and carefully maintained system of accounting records, there is internal consistency discoverable through such procedures that constitutes persuasive evidence that the financial statements do present financial position, results of operations, and cash flows in conformity with generally

accepted accounting principles. [Formerly paragraph .16, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.18 The pertinent documentary material to support entries in the accounts and assertions in the financial statements ordinarily is on hand in the company's files and available to the auditor for examination. Both within the company's organization and outside it are knowledgeable people to whom the auditor can direct inquiries. Assets having physical existence are available to the auditor for his inspection. Activities of company personnel can be observed. Based on certain conditions or circumstances as he observes them, for example, a low assessed level of control risk, he can reason to conclusions with respect to the validity of various assertions in the financial statements. [Formerly paragraph .17, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

## Competence of Evidential Matter

.19 To be competent, evidence must be both valid and relevant. The validity of evidential matter is so dependent on the circumstances under which it is obtained that generalizations about the reliability of various types of evidence are subject to important exceptions. If the possibility of important exceptions is recognized, however, the following presumptions, which are not mutually exclusive, about the validity of evidential matter in auditing have some usefulness:

- a. When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity.
- b. The more effective the internal control structure, the more assurance it provides about the reliability of the accounting data and financial statements.
- c. The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.

[Formerly paragraph .18, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

## Sufficiency of Evidential Matter

.20 The independent auditor's objective is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion. The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his professional judgment after a careful study of the circumstances in the particular case. In the great majority of cases, the auditor finds it necessary to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles, are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being audited. [Formerly paragraph .19, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.21 An auditor typically works within economic limits; his opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost. The auditor must decide, again exercising professional judgment, whether the evidential matter available to him within the limits of time and cost is sufficient to justify expression of an opinion. [Formerly paragraph .20, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

.22 As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. The matter of difficulty and expense involved in testing a particular item is not in itself a valid basis for omitting the test. [Formerly paragraph .21, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

## **Evaluation of Evidential Matter**

.23 In evaluating evidential matter, the auditor considers whether specific audit objectives have been achieved. The independent auditor should be thorough in his search for evidential matter and unbiased in its evaluation. In designing audit procedures to obtain competent evidential matter, he should recognize the possibility that the financial statements may not be presented in conformity with generally accepted accounting principles. In developing his opinion, the auditor should give consideration to relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. To the extent the auditor remains in substantial doubt about any assertion of material significance, he must refrain from forming an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion. [Formerly paragraph .22, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

## Appendix

### .24 Financial Statement Assertions, Illustrative Audit Objectives, and Examples of Substantive Tests

#### Illustrations for Inventories of a Manufacturing Company

This appendix illustrates the use of assertions in developing audit objectives and designing substantive tests. The following examples of substantive tests are not intended to be all-inclusive nor is it expected that all of the procedures would be applied in an audit.

<u>Illustrative Audit Objectives</u>	<u>Examples of Substantive Tests</u>
<u>Existence or Occurrence</u>	
Inventories included in the balance sheet physically exist	<ul style="list-style-type: none"> <li>● Observing physical inventory counts.</li> <li>● Obtaining confirmation of inventories at locations outside the entity.</li> <li>● Testing of inventory transactions between a preliminary physical inventory date and the balance sheet date.</li> </ul>
Inventories represent items held for sale or use in the normal course of business.	<ul style="list-style-type: none"> <li>● Reviewing perpetual inventory records, production records, and purchasing records for indications of current activity.</li> <li>● Comparing inventories with a current sales catalog and subsequent sales and delivery reports.</li> <li>● Using the work of specialists to corroborate the nature of specialized products.</li> </ul>
<u>Completeness</u>	
Inventory quantities include all products, materials, and supplies on hand.	<ul style="list-style-type: none"> <li>● Observing physical inventory counts.</li> <li>● Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.</li> <li>● Testing shipping and receiving cutoff procedures.</li> </ul>
Inventory quantities include all products, materials, and supplies owned by the company that are in transit or stored at outside locations.	<ul style="list-style-type: none"> <li>● Obtaining confirmation of inventories at locations outside the entity.</li> <li>● Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.</li> <li>● Testing shipping and receiving cutoff procedures.</li> </ul>



Illustrative AuditObjectives

Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.

Examples of Substantive Tests

- Tracing test counts recorded during the physical inventory observation to the inventory listing.
- Accounting for all inventory tags and count sheets used in recording the physical inventory counts.
- Testing the clerical accuracy of inventory listings.
- Reconciling physical counts to perpetual records and general ledger balances and investigating significant fluctuations.

Rights and Obligations

The entity has legal title or similar rights of ownership to the inventories.

- Observing physical inventory counts.
- Obtaining confirmation of inventories at locations outside the entity.
- Examining paid vendors' invoices, consignment agreements, and contracts.

Inventories exclude items billed to customers or owned by others.

- Examining paid vendors' invoices, consignment agreements, and contracts.
- Testing shipping and receiving cutoff procedures.

Valuation or Allocation

Inventories are properly stated at cost (except when market is lower).

- Examining paid vendors' invoices.
- Reviewing direct labor rates.
- Testing the computation of standard overhead rates.
- Examining analyses of purchasing and manufacturing standard cost variances.

Slow-moving, excess, defective, and obsolete items included in inventories are properly identified.

- Examining an analysis of inventory turnover.
- Reviewing industry experience and trends.
- Analytically comparing the relationship of inventory balances to anticipated sales volume.
- Touring the plant.
- Inquiring of production and sales personnel concerning possible excess or obsolete inventory items.

Illustrative AuditObjectives

Inventories are reduced, when appropriate, to replacement cost or net realizable value.

Examples of Substantive Tests

- Obtaining current market value quotations.
- Reviewing current production costs.
- Examining sales after year-end and open purchase order commitments.

Presentation and Disclosure

Inventories are properly classified in the balance sheet as current assets.

The major categories of inventories and their bases of valuation are adequately disclosed in the financial statements.

The pledge or assignment of any inventories is appropriately disclosed.

[Formerly paragraph .23, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

- Reviewing drafts of the financial statements.
- Reviewing drafts of the financial statements.
- Comparing the disclosures made in the financial statements to the requirements of generally accepted accounting principles.
- Obtaining confirmation of inventories pledged under loan agreements.

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[The next page is 321-51.]

**AU Section 9326*****Evidential Matter: Auditing Interpretations of Section 326*****1. Evidential Matter for an Audit of Interim Financial Statements**

**.01 Question**—APB Opinion No. 28 [AC section I73] concluded that certain accounting principles and practices followed for annual reporting purposes may require modification at interim reports dates. Paragraph 10 of Opinion No. 28 [AC section I73.103] states that the modifications are needed “so that the reported results for the interim period may better relate to the results of operations for the annual period.” The modifications introduce a need for estimates to a greater extent than is necessary for annual financial information. Does this imply a relaxation of the third standard of field work, which requires that sufficient competent evidential matter be obtained to afford a reasonable basis for an opinion regarding the financial statements under audit?

**.02 Interpretation**—No. The third standard of field work applies to all engagements leading to an expression of opinion on financial statements or financial information.

**.03** The objective of the independent auditor’s engagement is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion. The auditor develops specific audit objectives in light of assertions by management that are embodied in financial statement components. Section 326.11 states, “In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the risk of material misstatement of the financial statements, including the assessed level of control risk, and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved.”

**.04** Evidential matter obtained for an audit of annual financial statements may also be useful in an audit of interim financial statements, and evidential matter obtained for an audit of interim financial statements may also be useful in an audit of annual financial statements. Section 313.02 indicates that “Audit testing at interim dates may permit early consideration of significant matters affecting the year-end financial statements (for example, related party transactions, changed conditions, recent accounting pronouncements, and financial statement items likely to require adjustment)” and that “much of the audit planning, including obtaining an understanding of the internal control structure and assessing control risk, and the application of substantive tests to transactions can be conducted prior to the balance-sheet date.”<sup>1</sup> [As amended August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 313.)

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<sup>1</sup> See section 313, *Substantive Tests Prior to the Balance-Sheet Date* for guidance on the auditor’s considerations before applying substantive tests to the details of asset or liability accounts at interim dates, including the relationship between the assessed level of control risk and such tests, and on extending the audit conclusions from such tests to the balance-sheet date. [Footnote added August, 1983, by issuance of Statement on Auditing Standards No. 45.]

.05 The introduction by Opinion No. 28 [AC section I73] of a need for additional estimates in measuring certain items for interim financial information may lead to a need for evidence in examining those items that differs from the evidence required in an audit of annual financial information. For example, computing the provision for federal income taxes in interim information involves estimating the effective tax rate expected to be applicable for the full fiscal year, and the auditor should examine evidence as to the basis for estimating that rate. Since the effective tax rate for the full year ordinarily is known at year-end, similar evidence is not usually required in examining annual information.

[Issue Date: February, 1974; modified: October, 1980.]

## **2. The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals**

.06 *Question*—The Internal Revenue Service's audit manual instructs its examiners on how to secure from corporate officials "tax accrual workpapers" or the "tax liability contingency analysis," including, "a memorandum discussing items reflected in the financial statements as income or expense where the ultimate tax treatment is unclear." The audit manual states that the examiner may question or summons a corporate officer or manager concerning the "knowledge of the items that make up the corporation's contingent reserve accounts." It also states that "access may be had to the audit and tax workpapers of an independent accountant or an accounting firm" after attempting to obtain the information from the taxpayer. (Internal Revenue Manual, sections 4024.2-3, 6/12/80).

.07 Concern over IRS access to tax accrual working papers might cause some clients to not prepare or maintain appropriate documentation of the calculation or contents of the accrual for income taxes included in the financial statement, or to deny the independent auditor access to such information.

.08 What effect does this situation have on the auditor's opinion on the financial statements?

.09 *Interpretation*—Limitations on the auditor's access to information he considers necessary to audit the tax accrual will affect his ability to issue an unqualified opinion on the financial statements. Thus, if the client does not have appropriate documentation of the calculation or contents of the accrual for income taxes and denies the auditor access to client personnel responsible for making the judgments and estimates relating to the accrual, the auditor should assess the importance of that inadequacy in the accounting records and the client imposed limitation on his ability to form an opinion on the financial statements. Also, if the client has appropriate documentation but denies the auditor access to it and to client personnel who possess the information the auditor should assess the importance of the client-imposed scope limitation on his ability to form an opinion.

.10 The third standard of field work requires the auditor to obtain sufficient competent evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Section 326, *Evidential Matter*, paragraph .23, requires the auditor to obtain sufficient competent evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his opinion on the statements. Section 508, *Reports on Audited Financial Statements*, paragraph .42, states that, "When restrictions that significantly limit

the scope of the audit are imposed by the client, ordinarily the auditor generally should disclaim an opinion on the financial statements.” Also, section 333 on *Client Representations* requires the auditor to obtain written representations from management. Section 333.04 states that the representations ordinarily include, among other matters, “availability of all financial records and related data,” and section 333.05 states that a materiality limit does not apply to that representation. Section 333.11 states that “management’s refusal to furnish a written representation that the auditor believes is essential” constitutes a scope limitation. [Reference number 326.23, formerly 326.22, changed by the issuance of Statement on Auditing Standards No. 48.]

**.11 Question**—A client may allow the auditor to inspect its tax accrual workpapers, but may request that he not retain copies for his audit working papers, particularly of the tax liability contingency analysis. The client may also suggest that the auditor not prepare and maintain similar documentation of his own. What should the auditor consider in deciding his response to such a request?

**.12 Interpretation**—Section 326, *Evidential Matter*, paragraph .16, states that corroborating information includes information obtained by the auditor from inquiry, observation and inspection. Section 339 gives guidance on “Working Papers,” and states that they provide the principal record of conclusions the auditor has reached concerning significant matters and that ordinarily they should include, among other things, documentation showing that the audit evidence obtained afforded a reasonable basis for an opinion. The section also states that working papers may take the form of memoranda. The nature and extent of audit working paper documentation that is necessary to meet those requirements is a matter of the auditor’s professional judgment in light of the circumstances and his needs on the specific engagement. [As modified by the issuance of Statement on Auditing Standards No. 41.] (See section 339.) [Reference number 326.16, formerly 326.15, changed by the issuance of Statement on Auditing Standards No. 48.]

**.13 Question**—In some situations a client may furnish its outside legal counsel or in-house legal or tax counsel with information concerning the tax contingencies covered by the accrual for income taxes included in the financial statements and ask counsel to give the auditor an opinion on the adequacy of the accrual for those contingencies.

**.14** In such circumstances, instead of inspecting the client’s tax liability contingency analysis and making inquiries of the client, may the auditor consider the counsel as a specialist within the meaning of section 336, *Using the Work of a Specialist*, and rely solely on counsel’s opinion as an appropriate procedure for obtaining evidential matter to support his opinion on the financial statements?

**.15 Interpretation**—No. The opinion of legal counsel in this situation would not provide sufficient competent evidential matter to afford a reasonable basis for an opinion on the financial statements.

**.16** Section 336.01 defines a specialist as “a person or firm possessing special skill or knowledge in a particular field other than accounting or auditing.” It is intended to apply to situations requiring special knowledge of matters about which the auditor does not have adequate technical training and proficiency. The auditor’s education, training and experience on the other hand, do enable him to be knowledgeable concerning income tax matters and competent to assess their presentation in the financial statements.

[The next page is 321-55.]

.17 The opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention, as contemplated by section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, can be useful to the auditor in forming his own opinion. However, the audit of income tax accounts requires a combination of tax expertise and knowledge about the client's business that is accumulated during all aspects of an audit. Therefore, as stated above, it is not appropriate for the auditor to rely solely on such legal opinion.

[Issue Date: March, 1981.]

### 3. The Auditor's Consideration of the Completeness Assertion

.18 *Question*—Section 326, *Evidential Matter*, paragraph .03, identifies five categories of assertions that are embodied in financial statement components. In obtaining audit evidence about four of these categories—existence or occurrence, rights and obligations, valuation or allocation, and presentation and disclosure—the auditor considers transactions and accounts that are included in the financial statements. In contrast, in obtaining audit evidence about the completeness assertion, the auditor considers whether transactions and accounts have been improperly excluded from the financial statements. May management's written representations and the auditor's assessment of control risk constitute sufficient audit evidence about the completeness assertion?

.19 *Interpretation*—Written representations from management are a part of the evidential matter the auditor obtains in an audit performed in accordance with generally accepted auditing standards. Management's representations about the completeness assertion, whether considered alone or in combination with the auditor's assessment of control risk, do not constitute sufficient audit evidence to support that assertion. Obtaining such representations complements but does not replace other auditing procedures that the auditor should perform.

.20 In planning audit procedures to obtain evidence about the completeness assertion, the auditor should consider the inherent risk that transactions and accounts have been improperly omitted from the financial statements. When the auditor assesses the inherent risk of omission for a particular account balance or class of transactions to be such that he believes omissions could exist that might be material when aggregated with errors in other balances or classes, he should restrict the audit risk of omission by performing substantive tests designed to obtain evidence about the completeness assertion. Substantive tests designed primarily to obtain evidence about the completeness assertion include analytical procedures and tests of details of *related populations*.<sup>2</sup>

.21 The auditor's reliance on substantive tests of completeness may properly vary inversely with any assessed level of control risk below the maximum designed to provide reasonable assurance that all transactions and accounts that should be presented in the financial statements are so included. Because of the unique nature of the completeness assertion, an assessed level of control risk below the maximum may be an effective means for the auditor to obtain evidence about that assertion. Although an assessed level of control risk below the maximum is not required to satisfy the auditor's objectives with

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<sup>2</sup> For purposes of this interpretation, a related population is a population other than the recorded account balance or class of transactions being audited that would be expected to contain evidence of whether all accounts or transactions that should be presented in that balance or class are so included.

respect to the completeness assertion, the auditor should consider that for some transactions (e.g., revenues that are received primarily in cash, such as those of a casino or of some charitable organizations) it may be difficult to limit audit risk for those assertions to an acceptable level without an assessed level of control risk below the maximum.

[Issue Date: April, 1986.]

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## AU Section 329

### *Analytical Procedures*

(Supersedes section 318)

**Source:** SAS No. 56.

**Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.**

.01 This section provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits.

.02 Analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures range from simple comparisons to the use of complex models involving many relationships and elements of data. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. Particular conditions that can cause variations in these relationships include, for example, specific unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements.

.03 Understanding financial relationships is essential in planning and evaluating the results of analytical procedures, and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

.04 Analytical procedures are used for the following purposes:

- a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures
- b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions
- c. As an overall review of the financial information in the final review stage of the audit

Analytical procedures should be applied to some extent for the purposes referred to in (a) and (c) above for all audits of financial statements made in accordance with generally accepted auditing standards. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

.05 Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the



auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

- a. Financial information for comparable prior period(s) giving consideration to known changes
- b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data
- c. Relationships among elements of financial information within the period
- d. Information regarding the industry in which the client operates—for example, gross margin information
- e. Relationships of financial information with relevant nonfinancial information

## **Analytical Procedures in Planning the Audit**

**.06** The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (a) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date, and (b) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events, and amounts, ratios and trends that might indicate matters that have financial statement and audit planning ramifications.

**.07** Analytical procedures used in planning the audit generally use data aggregated at a high level. Furthermore, the sophistication, extent and timing of the procedures, which are based on the auditor's judgment, may vary widely depending on the size and complexity of the client. For some entities, the procedures may consist of reviewing changes in account balances from the prior to the current year using the general ledger or the auditor's preliminary or unadjusted working trial balance. In contrast, for other entities, the procedures might involve an extensive analysis of quarterly financial statements. In both cases, the analytical procedures, combined with the auditor's knowledge of the business, serve as a basis for additional inquiries and effective planning.

**.08** Although analytical procedures used in planning the audit often use only financial data, sometimes relevant nonfinancial information is considered as well. For example, number of employees, square footage of selling space, volume of goods produced, and similar information may contribute to accomplishing the purpose of the procedures.

## **Analytical Procedures Used as Substantive Tests**

**.09** The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion<sup>1</sup> may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment on the expected effectiveness and efficiency of the available procedures.

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<sup>1</sup> Assertions are representations by management that are embodied in financial statement components. See section 326, *Evidential Matter*.

.10 The auditor considers the level of assurance, if any, he wants from substantive testing for a particular audit objective and decides, among other things, which procedure, or combination of procedures, can provide that level of assurance. For some assertions, analytical procedures are effective in providing the appropriate level of assurance. For other assertions, however, analytical procedures may not be as effective or efficient as tests of details in providing the desired level of assurance.

.11 The expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things, (a) the nature of the assertion, (b) the plausibility and predictability of the relationship, (c) the availability and reliability of the data used to develop the expectation, and (d) the precision of the expectation.

### **Nature of Assertion**

.12 Analytical procedures may be effective and efficient tests for assertions in which potential misstatements would not be apparent from an examination of the detailed evidence or in which detailed evidence is not readily available. For example, comparisons of aggregate salaries paid with the number of personnel may indicate unauthorized payments that may not be apparent from testing individual transactions. Differences from expected relationships may also indicate potential omissions when independent evidence that an individual transaction should have been recorded may not be readily available.

### **Plausibility and Predictability of the Relationship**

.13 It is important for the auditor to understand the reasons that make relationships plausible because data sometimes appear to be related when they are not, which could lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship can provide important evidence when appropriately scrutinized.

.14 As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation. Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment. Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts since income statement accounts represent transactions over a period of time, whereas balance sheet accounts represent amounts as of a point in time. Relationships involving transactions subject to management discretion are sometimes less predictable. For example, management may elect to incur maintenance expense rather than replace plant and equipment, or they may delay advertising expenditures.

### **Availability and Reliability of Data**

.15 Data may or may not be readily available to develop expectations for some assertions. For example, to test the completeness assertion, expected sales for some entities might be developed from production statistics or square feet of selling space. For other entities, data relevant to the assertion of completeness of sales may not be readily available, and it may be more effective or efficient to use the details of shipping records to test that assertion.

.16 The auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the

analytical procedure. The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives:

- Whether the data was obtained from independent sources outside the entity or from sources within the entity
- Whether sources within the entity were independent of those who are responsible for the amount being audited
- Whether the data was developed under a reliable system with adequate controls
- Whether the data was subjected to audit testing in the current or prior year
- Whether the expectations were developed using data from a variety of sources

### **Precision of the Expectation**

.17 The expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate (see paragraph .20). As expectations become more precise, the range of expected differences becomes narrower and, accordingly, the likelihood increases that significant differences from the expectations are due to misstatements. The precision of the expectation depends on, among other things, the auditor's identification and consideration of factors that significantly affect the amount being audited and the level of detail of data used to develop the expectation.

.18 Many factors can influence financial relationships. For example, sales are affected by prices, volume and product mix. Each of these, in turn, may be affected by a number of factors, and offsetting factors can obscure misstatements. More effective identification of factors that significantly affect the relationship is generally needed as the desired level of assurance from analytical procedures increases.

.19 Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons. Monthly amounts will generally be more effective than annual amounts and comparisons by location or line of business usually will be more effective than company-wide comparisons. The level of detail that is appropriate will be influenced by the nature of the client, its size and its complexity. Generally, the risk that material misstatement could be obscured by offsetting factors increases as a client's operations become more complex and more diversified. Disaggregation helps reduce this risk.

### **Investigation and Evaluation of Significant Differences**

.20 In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account

balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.<sup>2</sup>

.21 The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a likely misstatement.<sup>3</sup> In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.)

## Analytical Procedures Used in the Overall Review

.22 The objective of analytical procedures used in the overall review stage of the audit is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation. A wide variety of analytical procedures may be useful for this purpose. The overall review would generally include reading the financial statements and notes and considering (a) the adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit and (b) unusual or unexpected balances or relationships that were not previously identified. Results of an overall review may indicate that additional evidence may be needed.

## Effective Date

.23 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

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[The next page is 329.]

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<sup>2</sup> See section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .17 through .19.

<sup>3</sup> See section 312.28.

## AU Section 330

### ***The Confirmation Process***

(Supersedes section 331.03—.08)

Source: SAS No. 67.

Effective for audits of fiscal periods ending after June 15, 1992, unless otherwise indicated.

### **Introduction and Applicability**

.01 This section provides guidance about the confirmation process in audits performed in accordance with generally accepted auditing standards. This section—

- Defines the confirmation process (see paragraph .04).
- Discusses the relationship of confirmation procedures to the auditor's assessment of audit risk (see paragraphs .05 through .10).
- Describes certain factors that affect the reliability of confirmations (see paragraphs .16 through .27).
- Provides guidance on performing alternative procedures when responses to confirmation requests are not received (see paragraphs .31 and .32).
- Provides guidance on evaluating the results of confirmation procedures (see paragraph .33).
- Specifically addresses the confirmation of accounts receivable and supersedes section 331, *Inventories*, paragraphs .03—.08 and the portion of section 331.01 that addresses the confirmation of receivables (see paragraphs .34 and .35). This section does not supersede the portion of section 331.01 that addresses the observation of inventories.

.02 This section does not address the extent or timing of confirmation procedures. Guidance on the extent of audit procedures (that is, considerations involved in determining the number of items to confirm) is found in section 350, *Audit Sampling*, and section 312, *Audit Risk and Materiality in Conducting an Audit*. Guidance on the timing of audit procedures is included in section 313, *Substantive Tests Prior to the Balance-Sheet Date*.

.03 In addition, this section does not address matters described in section 336, *Using the Work of a Specialist*, or in section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

### **Definition of the Confirmation Process**

.04 Confirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions. The process includes—

- Selecting items for which confirmations are to be requested.
- Designing the confirmation request.
- Communicating the confirmation request to the appropriate third party.
- Obtaining the response from the third party.

[The next page is 329-3.]

- Evaluating the information, or lack thereof, provided by the third party about the audit objectives, including the reliability of that information.

## Relationship of Confirmation Procedures to the Auditor's Assessment of Audit Risk

.05 Section 312 discusses the audit risk model. It describes the concept of assessing inherent and control risks, determining the acceptable level of detection risk, and designing an audit program to achieve an appropriately low level of audit risk. The auditor uses the audit risk assessment in determining the audit procedures to be applied, including whether they should include confirmation.

.06 Confirmation is undertaken to obtain evidence from third parties about financial statement assertions made by management. Section 326, *Evidential Matter*, states that, in general, it is presumed that "When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity."

.07 The greater the combined assessed level of inherent and control risk, the greater the assurance that the auditor needs from substantive tests related to a financial statement assertion. Consequently, as the combined assessed level of inherent and control risk increases, the auditor designs substantive tests to obtain more or different evidence about a financial statement assertion. In these situations, the auditor might use confirmation procedures rather than or in conjunction with tests directed toward documents or parties within the entity.

.08 Unusual or complex transactions may be associated with high levels of inherent risk and control risk. If the entity has entered into an unusual or complex transaction and the combined assessed level of inherent and control risk is high, the auditor should consider confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity. For example, if the combined assessed level of inherent and control risk over the occurrence of revenue related to an unusual, year-end sale is high, the auditor should consider confirming the terms of that sale.

.09 The auditor should assess whether the evidence provided by confirmations reduces audit risk for the related assertions to an acceptably low level. In making that assessment, the auditor should consider the materiality of the account balance and his or her inherent and control risk assessments. When the auditor concludes that evidence provided by confirmations alone is not sufficient, additional procedures should be performed. For example, to achieve an appropriately low level of audit risk related to the completeness and existence assertions for accounts receivable, an auditor may perform sales cutoff tests in addition to confirming accounts receivable.

.10 The lower the combined assessed level of inherent and control risk, the less assurance the auditor needs from substantive tests to form a conclusion about a financial statement assertion. Consequently, as the combined assessed level of inherent and control risk decreases for a particular assertion, the auditor may modify substantive tests by changing their nature from more effective (but costly) tests to less effective (and less costly) tests. For example, if the combined assessed level of inherent and control risk over the existence of cash is low, the auditor might limit substantive procedures to inspecting client-provided bank statements rather than confirming cash balances.

### Assertions Addressed by Confirmations

.11 For the evidence obtained to be competent, it must be reliable and relevant. Factors affecting the reliability of confirmations are discussed in paragraphs .16 through .27. The relevance of evidence depends on its relationship to the financial statement assertion being addressed. Section 326 classifies financial statement assertions into five categories:

- a. Existence or occurrence
- b. Completeness
- c. Rights and obligations
- d. Valuation or allocation
- e. Presentation and disclosure

.12 Confirmation requests, if properly designed by the auditor, may address any one or more of those assertions. However, confirmations do not address all assertions equally well. Confirmation of goods held on consignment with the consignee would likely be more effective for the existence and the rights-and-obligations assertions than for the valuation assertion. Accounts receivable confirmations are likely to be more effective for the existence assertion than for the completeness and valuation assertions. Thus, when obtaining evidence for assertions not adequately addressed by confirmations, auditors should consider other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

.13 Confirmation requests can be designed to elicit evidence that addresses the completeness assertion: that is, if properly designed, confirmations may provide evidence to aid in assessing whether all transactions and accounts that should be included in the financial statements are included. Their effectiveness in addressing the completeness assertion depends, in part, on whether the auditor selects from an appropriate population for testing. For example, when using confirmations to provide evidence about the completeness assertion for accounts payable, the appropriate population might be a list of vendors rather than the amounts recorded in the accounts payable subsidiary ledger.

.14 Some confirmation requests are not designed to elicit evidence regarding the completeness assertion. For example, the AICPA Standard Form to Confirm Account Balance Information With Financial Institutions is designed to substantiate information that is stated on the confirmation request; the form is not designed to provide assurance that information about accounts not listed on the form will be reported.

### The Confirmation Process

.15 The auditor should exercise an appropriate level of professional skepticism throughout the confirmation process (see section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*). Professional skepticism is important in designing the confirmation request, performing the confirmation procedures, and evaluating the results of the confirmation procedures.

### Designing the Confirmation Request

.16 Confirmation requests should be tailored to the specific audit objectives. Thus, when designing the confirmation requests, the auditor should consider the assertion(s) being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the confirmation request, prior experience on the audit or similar engagements,

the nature of the information being confirmed, and the intended respondent should affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through confirmation procedures.

### Form of Confirmation Request

.17 There are two types of confirmation requests: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she agrees with the information stated on the request. Other positive forms, referred to as blank forms, do not state the amount (or other information) on the confirmation request, but request the recipient to fill in the balance or furnish other information.

.18 Positive forms provide audit evidence only when responses are received from the recipients; nonresponses do not provide audit evidence about the financial statement assertions being addressed.

.19 Since there is a risk that recipients of a positive form of confirmation request with the information to be confirmed contained on it may sign and return the confirmation without verifying that the information is correct, blank forms may be used as one way to mitigate this risk. Thus, the use of blank confirmation requests may provide a greater degree of assurance about the information confirmed. However, blank forms might result in lower response rates because additional effort may be required of the recipients; consequently, the auditor may have to perform more alternative procedures.

.20 The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when (a) the combined assessed level of inherent and control risk is low, (b) a large number of small balances is involved, and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. For example, in the examination of demand deposit accounts in a financial institution, it may be appropriate for an auditor to include negative confirmation requests with the customers' regular statements when the combined assessed level of inherent and control risk is low and the auditor has no reason to believe that the recipients will not consider the requests. The auditor should consider performing other substantive procedures to supplement the use of negative confirmations.

.21 Negative confirmation requests may generate responses indicating misstatements, and are more likely to do so if the auditor sends a large number of negative confirmation requests and such misstatements are widespread. The auditor should investigate relevant information provided on negative confirmations that have been returned to the auditor to determine the effect such information may have on the audit. If the auditor's investigation of responses to negative confirmation requests indicates a pattern of misstatements, the auditor should reconsider his or her combined assessed level of inherent and control risk and consider the effect on planned audit procedures.

.22 Although returned negative confirmations may provide evidence about the financial statement assertions, unreturned negative confirmation requests rarely provide significant evidence concerning financial statement assertions other than certain aspects of the existence assertion. For example, negative confirmations may provide some evidence of the existence of third parties if they are not returned with an indication that the addressees are unknown. However, unreturned negative confirmations do not provide explicit



evidence that the intended third parties received the confirmation requests and verified that the information contained on them is correct.

### **Prior Experience**

.23 In determining the effectiveness and efficiency of employing confirmation procedures, the auditor may consider information from prior years' audits or audits of similar entities. This information includes response rates, knowledge of misstatements identified during prior years' audits, and any knowledge of inaccurate information on returned confirmations. For example, if the auditor has experienced poor response rates to properly designed confirmation requests in prior audits, the auditor may instead consider obtaining audit evidence from other sources.

### **Nature of Information Being Confirmed**

.24 When designing confirmation requests, the auditor should consider the types of information respondents will be readily able to confirm, since the nature of the information being confirmed may directly affect the competence of the evidence obtained as well as the response rate. For example, certain respondents' accounting systems may facilitate the confirmation of single transactions rather than of entire account balances. In addition, respondents may not be able to confirm the balances of their installment loans, but they may be able to confirm whether their payments are up-to-date, the amount of the payment, and the key terms of their loans.

.25 The auditor's understanding of the client's arrangements and transactions with third parties is key to determining the information to be confirmed. The auditor should obtain an understanding of the substance of such arrangements and transactions to determine the appropriate information to include on the confirmation request. The auditor should consider requesting confirmation of the terms of unusual agreements or transactions, such as bill and hold sales,<sup>1</sup> in addition to the amounts. The auditor also should consider whether there may be oral modifications to agreements, such as unusual payment terms or liberal rights of return. When the auditor believes there is a moderate or high degree of risk that there may be significant oral modifications, he or she should inquire about the existence and details of any such modifications to written agreements. One method of doing so is to confirm both the terms of the agreements and whether any oral modifications exist.

### **Respondent**

.26 The auditor should direct the confirmation request to a third party who the auditor believes is knowledgeable about the information to be confirmed. For example, to confirm a client's oral and written guarantees with a financial institution, the auditor should direct the request to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements.

.27 If information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity<sup>2</sup> comes to the auditor's attention, the auditor should consider the effects of such information on designing the confirmation request and evaluating the results, including

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<sup>1</sup> Bill and hold sales are sales of merchandise that are billed to customers before delivery and are held by the entity for the customers.

<sup>2</sup> Section 334, *Related Parties*, paragraphs .09 and .10, provide guidance on examining related-party transactions that have been identified by the auditor.

determining whether other procedures are necessary. In addition, there may be circumstances (such as for significant, unusual year-end transactions that have a material effect on the financial statements or where the respondent is the custodian of a material amount of the audited entity's assets) in which the auditor should exercise a heightened degree of professional skepticism relative to these factors about the respondent. In these circumstances, the auditor should consider whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect the response will provide meaningful and competent evidence.

### Performing Confirmation Procedures

.28 During the performance of confirmation procedures, the auditor should maintain control over the confirmation requests and responses. Maintaining control<sup>3</sup> means establishing direct communication between the intended recipient and the auditor to minimize the possibility that the results will be biased because of interception and alteration of the confirmation requests or responses.

.29 There may be situations in which the respondent, because of timeliness or other considerations, responds to a confirmation request other than in a written communication mailed to the auditor. When such responses are received, additional evidence may be required to support their validity. For example, facsimile responses involve risks because of the difficulty of ascertaining the sources of the responses. To restrict the risks associated with facsimile responses and treat the confirmations as valid audit evidence, the auditor should consider taking certain precautions, such as verifying the source and contents of a facsimile response in a telephone call to the purported sender. In addition, the auditor should consider requesting the purported sender to mail the *original* confirmation directly to the auditor. Oral confirmations should be documented in the workpapers. If the information in the oral confirmations is significant, the auditor should request the parties involved to submit written confirmation of the specific information directly to the auditor.

.30 When using confirmation requests other than the negative form, the auditor should generally follow up with a second and sometimes a third request to those parties from whom replies have not been received.

### Alternative Procedures

.31 When the auditor has not received replies to positive confirmation requests, he or she should apply alternative procedures to the nonresponses to obtain the evidence necessary to reduce audit risk to an acceptably low level. However, the omission of alternative procedures may be acceptable (a ) when the auditor has not identified unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions, and (b ) when testing for overstatement of amounts, the nonresponses in the aggregate, when projected as 100 percent misstatements to the population and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially misstated.

.32 The nature of alternative procedures varies according to the account and assertion in question. In the examination of accounts receivable, for example, alternative procedures may include examination of subsequent cash

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<sup>3</sup> The need to maintain control does not preclude the use of internal auditors in the confirmation process. Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor.

receipts (including matching such receipts with the actual items being paid), shipping documents, or other client documentation to provide evidence for the existence assertion. In the examination of accounts payable, for example, alternative procedures may include examination of subsequent cash disbursements, correspondence from third parties, or other records to provide evidence for the completeness assertion.

## Evaluating the Results of Confirmation Procedures

.33 After performing any alternative procedures, the auditor should evaluate the combined evidence provided by the confirmations and the alternative procedures to determine whether sufficient evidence has been obtained about all the applicable financial statement assertions. In performing that evaluation, the auditor should consider (a) the reliability of the confirmations and alternative procedures; (b) the nature of any exceptions, including the implications, both quantitative and qualitative, of those exceptions; (c) the evidence provided by other procedures; and (d) whether additional evidence is needed. If the combined evidence provided by the confirmations, alternative procedures, and other procedures is not sufficient, the auditor should request additional confirmations or extend other tests, such as tests of details or analytical procedures.

## Confirmation of Accounts Receivable

.34 For the purpose of this section, *accounts receivable* means—

- a. The entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and
- b. A financial institution's loans.

Confirmation of accounts receivable is a generally accepted auditing procedure. As discussed in paragraph .06, it is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity. Thus, there is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless one of the following is true:

- Accounts receivable are immaterial to the financial statements.
- The use of confirmations would be ineffective.<sup>4</sup>
- The auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions. In many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

.35 An auditor who has not requested confirmations in the examination of accounts receivable should document how he or she overcame this presumption.

## Effective Date

.36 This section is effective for audits of fiscal periods ending after June 15, 1992. Early application of this section is permissible.

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<sup>4</sup> For example, if, based on prior years' audit experience or on experience with similar engagements, the auditor concludes that response rates to properly designed confirmation requests will be inadequate, or if responses are known or expected to be unreliable, the auditor may determine that the use of confirmations would be ineffective.

## AU Section 331

### *Inventories*\*

Sources: SAS No. 1, section 331; SAS No. 43; SAS No. 67.

See section 9331 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 Observation of inventories is a generally accepted auditing procedure. The independent auditor who issues an opinion when he has not employed them must bear in mind that he has the burden of justifying the opinion expressed. [As amended, effective for fiscal periods ending after June 15, 1992, by Statement on Auditing Standards No. 67.] (See section 330.)

.02 The purpose of this section is to provide guidelines for the independent auditor in observing inventories. This section relates only to observation of inventories and does not deal with other important auditing procedures which generally are required for the independent auditor to satisfy himself as to these assets. [Modified, December 1991, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 67.] (See section 330.)

### **Receivables**

[.03—.08] [Superseded November 1991 by Statement on Auditing Standards No. 67.] (See section 330.)<sup>[1]</sup> <sup>[2]</sup>

### **Inventories**

.09 When inventory quantities are determined solely by means of a physical count, and all counts are made as of the balance-sheet date or as of a single date within a reasonable time before or after the balance-sheet date, it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories.

.10 When the well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, the auditor's observation procedures usually can be performed either during or after the end of the period under audit.

.11 In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy him-

\* [Title amended, December 1991, by Statement on Auditing Standards No. 67.] (See section 330.)

<sup>[1]</sup> [Superseded November 1991, by Statement on Auditing Standards No. 67.] (See section 330.)

<sup>[2]</sup> [Superseded November 1991, by Statement on Auditing Standards No. 67.] (See section 330.)

self that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used. If statistical sampling methods are used by the client in the taking of the physical inventory, the auditor must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that the results are reasonable in the circumstances. [As modified by the issuance of SAS No. 39.] (See section 350.)

.12 When the independent auditor has not satisfied himself as to inventories in the possession of the client through the procedures described in paragraphs .09—.11, tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions. This should be coupled with inspection of the records of any client's counts and procedures relating to the physical inventory on which the balance-sheet inventory is based.

.13 The independent auditor may be asked to audit financial statements covering the current period and one or more periods for which he had not observed or made some physical counts of prior inventories. He may, nevertheless, be able to become satisfied as to such prior inventories through appropriate procedures, such as tests of prior transactions, reviews of the records of prior counts, and the application of gross profit tests, provided that he has been able to become satisfied as to the current inventory.

### **Inventories Held in Public Warehouses<sup>3</sup>**

.14 If inventories are in the hands of public warehouses or other outside custodians, the auditor ordinarily would obtain direct confirmation in writing from the custodian. If such inventories represent a significant proportion of current or total assets, to obtain reasonable assurance with respect to their existence, the auditor should apply one or more of the following procedures as he considers necessary in the circumstances.

- a. Test the owner's procedures for investigating the warehouseman and evaluating the warehouseman's performance.
- b. Obtain an independent accountant's report on the warehouseman's control procedures relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable.
- c. Observe physical counts of the goods, if practicable and reasonable.
- d. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate).

[As amended, (by replacing paragraphs .14 and .15 with a new paragraph .14), effective after August 31, 1982 by Statement on Auditing Standards No. 43.]

### **Effect on the Auditor's Report**

.15 For a discussion of the circumstances relating to receivables and inventories affecting the independent auditor's report, see sections 508.42 and 508.76. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2. Formerly paragraph .16, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

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[The next page is 335.]

<sup>3</sup> See section 901 for Special Report of Committee on Auditing Procedure.

**AU Section 9331*****Inventories: Auditing Interpretations of Section 331*****1. Evidential Matter for Inventories at Interim Dates**

**.01 Question**—Paragraph 14 of APB Opinion No. 28 [AC section 173.107] states that “companies should generally use the same inventory pricing methods and make provisions for writedowns to market at interim dates on the same basis as used at annual inventory dates,” and further states that there are four exceptions that are appropriate at interim reporting dates, including the use of estimated gross profit rates to determine the cost of goods sold for interim periods. What effect does the use of such estimates have on the auditor’s examination of inventories for the interim period?

**.02 Interpretation**—The auditor’s objective in examining evidence as to the amounts shown for cost of goods sold and inventories in interim information should be to satisfy himself that the client’s estimate produces results that are substantially the same as those that would be obtained by following year-end procedures. Examining such evidence may not provide the auditor with sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under audit.

**.03** Performing procedures with respect to the reasonableness of estimates used to determine cost of goods sold and inventories is not unlike performing procedures for an annual audit when inventory is not counted at the year-end date (see sections 313 and 331.09, .10 and .13). The considerations that influence the auditor in deciding whether the procedures performed provide him with sufficient competent evidential matter for interim financial information are similar to those for annual financial information. Section 326.11 states, “In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the risk of material misstatement of the financial statements, including the assessed level of control risk, and the expected effectiveness and efficiency of such test. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved.” [Reference changes to section 313 August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 313.)

**.04** The auditor’s decision as to the sufficiency and competence of the evidence available to support the amounts reported for cost of goods sold and for inventories will be influenced by many factors, among which are

1. The length of time that has elapsed since the most recent physical count.
2. The auditor’s past experience with the client.
3. The auditor’s knowledge of the nature of the client’s business and the current business conditions.
4. The materiality of possible misstatement.
5. The nature and condition of the client’s accounting records and system.

6. The existence of records that provide information as to inventory changes, such as shipments made, scrap, waste, obsolescence and shrinkage.

.05 The auditor ordinarily has more evidence available to evaluate the validity of estimates when the client's accounting system provides information as to changes in inventory. If the client's accounting records reflect the allocation and classification of transactions with persons outside the company but not inventory changes, the auditor is not likely to have the necessary evidence to support estimates of costs of goods sold and inventories. In either case the auditor must evaluate all relevant factors in deciding whether there is sufficient competent evidential matter.

[Issue Date: February, 1974; modified: October, 1980.]

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[The next page is 341.]

## AU Section 332

### ***Long-Term Investments***

Sources: SAS No. 1, section 332; SAS No. 2.

See section 9332 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The purpose of this section is to furnish guidance in applying generally accepted auditing standards to audits of the financial statements of companies with long-term investments accounted for under either the cost method or the equity method. Such investments may be represented by capital stock or other equity interests, bonds and similar debt obligations, and loans and advances that are in the nature of investments. This section is concerned with evidential matter which should be examined by the auditor in corroboration of (a) amounts at which long-term investments are stated in financial statements of the investor, (b) amounts reported as the investor's share of earnings or losses and other transactions of the investee, and (c) related disclosures.

#### **Objectives of Examination**

.02 The independent auditor should ascertain whether long-term investments are accounted for in conformity with generally accepted accounting principles consistently applied and whether the related disclosures are adequate. He should, therefore, examine sufficient competent evidential matter supporting the existence, ownership, cost, and carrying amount of investments, income and losses attributable to such investments, and any related disclosures in the investor's financial statements. With respect to investments accounted for under the equity method, he should also examine such evidential matter regarding the investor's accounting for its share of capital and other transactions of the investee.

.03 With respect to the carrying amount of investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor.\* The independent auditor should, therefore, also examine sufficient competent evidential matter to the extent he deems necessary to determine whether such a loss in value has occurred.

#### **Types of Evidence**

.04 Evidential matter pertaining to the existence, ownership, and cost of long-term investments includes accounting records and documents of the investor relating to their acquisition. In the case of investments in the form of securities (such as stocks, bonds, and notes), this evidential matter should be corroborated by inspection of the securities, or in appropriate circumstances, by written confirmation from an independent custodian of securities on deposit, pledged, or in safekeeping. In the case of loans, advances, and registered bonds and similar debt obligations, evidential matter obtained from

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\* See FASB Statement No. 12 [AC section I89], *Accounting for Certain Marketable Securities*.



accounting records and documents also should be corroborated by written confirmation from the debtor or trustee.

.05 Evidential matter pertaining to the carrying amount of long-term investments, income and losses attributable to such investments, and capital and other transactions of the investee may be available in the following forms:

a. Audited Financial Statements

Financial statements of the investee generally constitute sufficient evidential matter as to the equity in underlying net assets and results of operations of the investee when such statements have been audited by the investor's auditor or by another independent auditor whose report is satisfactory, for this purpose, to the investor's auditor. Audited financial statements also constitute one of the items of evidential matter that may be used with respect to investments in bonds and similar debt obligations, loans, and advances.

b. Unaudited Financial Statements

- (i) Unaudited financial statements, reports issued on examination by regulatory bodies and taxing authorities, and similar data provide information and evidence but are not by themselves sufficient as evidential matter.
- (ii) By application of auditing procedures to the financial statements of an investee, the auditor obtains evidential matter as to the equity in underlying net assets and results of operations of the investee. The auditor for the investor may utilize the investee's auditor for this purpose. The materiality of the investment in relation to the financial statements of the investor is a factor which should be considered in determining the extent and nature of such procedures.

c. Market Quotations

If market quotations of security prices are based on a reasonably broad and active market, they ordinarily constitute sufficient competent evidential matter as to the current market value of unrestricted securities.

d. Other Evidential Matter

- (i) When the carrying amount of an investment reflects (a) factors (such as mineral rights, growing timber, patents, and goodwill) which are not recognized in financial statements of the investee or (b) fair values of assets which are materially different from the investee's carrying amounts, evidential matter may be available in the form of current evaluations of these factors. Evaluations made by persons within the investor or within the investee may be acceptable; evaluations made by persons independent of these companies will usually provide greater assurance of reliability than evaluations made by persons within the companies.
- (ii) Negotiable securities, real estate, chattels, or other property are often assigned as collateral for investments in bonds, notes, loans, or advances. If the collateral is an important factor in considering collectibility of the obligation, the auditor should satisfy himself regarding the existence and transferability of such collateral and should obtain evidential matter as to its value (such as market

quotations, the amount of underlying net assets, or appraisals) as may be appropriate in the circumstances.

## Equity Method of Accounting

**.06** Paragraph 17 of Accounting Principles Board Opinion No. 18 [AC section I82.104] states that the equity method of accounting for an investment in common stock should be used by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. It also provides criteria to be considered in determining whether the investor has the ability to exercise significant influence. Paragraph 16 of Opinion No. 18 [AC section I82.103] states that the equity method should also be followed for investments in common stock of corporate joint ventures.

**.07** The auditor has a responsibility to satisfy himself with respect to the appropriateness of the accounting method adopted for investments in voting stock of an investee. Inquiry should be made of the investor's management as to (a) whether the investor has the ability to exercise significant influence over operating and financial policies of the investee under the criteria set forth in paragraph 17 of Opinion No. 18 [AC section I82.104] and (b) the attendant circumstances which serve as a basis for management's conclusion. The auditor should evaluate the information received on the basis of facts otherwise obtained by him in the course of his audit.

**.08** When an investor accounts for an investment in an investee contrary to the applicable presumption contained in paragraph 17 of Opinion No. 18<sup>1</sup> [AC section I82.104], the auditor should obtain sufficient competent evidential matter to satisfy himself that such presumption has been overcome and that appropriate disclosure is made regarding the reasons for not accounting for the investment in keeping with the presumption.<sup>2</sup>

**.09** The refusal of an investee to furnish necessary financial data to the investor is evidence (but not necessarily conclusive evidence) that the investor does not have the ability to exercise significant influence over operating and financial policies of the investee such as to justify the application of the equity method of accounting for investments in 50% or less owned companies in accordance with the provisions of Opinion No. 18 [AC section I82].\*

**.10** An investor should include its proportionate share of an investee's results of operations based on data obtained from the investee's most recent reliable financial statements, which may be its audited year-end statements.

**.11** An investor may include its proportionate share of the results of operations of an investee based on the investee's unaudited interim financial statements. An example of this would be a situation in which an investor whose year ends on June 30 includes its equity in earnings of an investee based on the investee's financial statements for the six-month period ended December 31 and the six-month period ended June 30. In such situations, the auditor for the investor should recognize that although the investee's financial state-

<sup>1</sup> Paragraph 17 [AC section I82.104] states: "... an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such an ability can be demonstrated."

<sup>2</sup> See Accounting Principles Board Opinion No. 18, paragraph 20, footnote 13 [AC section I82.110, footnote 14].

\* See also FASB Interpretation No. 35, paragraph 4(d) [AC section I82.108(d)].

ments for the year ended December 31 may have been audited, the financial statements as of June 30 and for the year then ended represent unaudited data because neither six-month period is covered by an auditor's report. Auditing procedures (see paragraph .05 b(ii)) should be applied to such unaudited financial statements to the extent considered necessary in view of their materiality in relation to the financial statements of the investor.

.12 In many instances there will be a time lag in reporting between the dates of the financial statements of the investor and those of the investee. A time lag in reporting should be consistent from period to period. If a change in time lag occurs which the auditor deems to have a material effect on the investor's financial statements, he should add an explanatory paragraph to his report because of the change in reporting period. (See section 508.34—.36).

.13 With respect to events and transactions of the investee from the date of the investee's financial statements to the date of the report of the auditor of the investor, the auditor should read available interim financial statements of the investee and make appropriate inquiries of the investor. Further, the auditor should ascertain through such inquiries that the investor has made itself aware of any material events or transactions arising subsequent to the date of the investee's financial statements. Such events or transactions of the type contemplated by section 560.05—.06, which are material in relation to the financial statements of the investor, should be disclosed in the notes to the investor's financial statements and (where applicable) labeled as unaudited information. For the purpose of recording the investor's share of the results of operations of the investee, recognition should be given to events or transactions of the type contemplated by section 560.03 which are material in relation to the financial statements of the investor.

.14 In certain circumstances, events or transactions during the period between the date of the investee's financial statements and the date of the investor's financial statements may be of such a nature and significance as to cause a loss in value of the investment which should be recognized in the investor's financial statements (see paragraph 19h of Opinion No. 18) [AC section I82.109h].

.15 For investments accounted for under the equity method, data relating to transactions between the investor and investee should be obtained for purposes of determining the proper elimination of unrealized intercompany profits and losses. Normally, such data are not shown separately in the financial statements of the investee and may have to be obtained from the investee. If the amounts of unrealized intercompany profits or losses could reasonably be expected to be material in relation to the investor's financial position or results of operations, unaudited data obtained from the investee ordinarily should be subjected to auditing procedures (see paragraph .05 b(ii)).

## **Effect on the Auditor's Report**

.16 For a discussion of circumstances relating to long-term investments affecting the independent auditor's report, see sections 508.42 and .44, and 543.14. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.]

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[The next page is 347.]

**AU Section 9332*****Long-Term Investments: Auditing Interpretations of Section 332*****1. Evidential Matter for the Carrying Amount of Marketable Securities\***

**.01 Question**—Section 332.03, states: “With respect to the carrying amount of [long-term] investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor.” ARB No. 43, chapter 3A, paragraph 9, with respect to working capital and current assets, states: “In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value.” What evidence should the auditor obtain pertaining to the classification and the carrying amount of marketable securities when market value is below cost?

**.02 Interpretation**—Section 508, *Reports on Audited Financial Statements*, paragraph .21 states: “In preparing financial statements, management estimates the outcome of certain types of future events.” Estimates of the outcome of future events include determining the proper carrying amount for securities when market value is below cost. The auditor should examine evidence to determine whether management properly classified the marketable securities as current or noncurrent assets and whether the amount at which they are carried in the financial statements are appropriate. The auditor should evaluate the reasons for the market decline when market value is below cost.

**.03 Declines in market value** may be temporary in nature or may reflect conditions that are more persistent. The distinction between temporary and persistent, however, has been largely undefined. Declines may result primarily from daily market fluctuations or from short-term variations in general economic or market conditions that are temporary in nature. Declines may also be attributable to general economic and money market conditions that persist for other than a temporary time period. Other market declines may be attributable to specific adverse conditions that affect a particular company's securities.

**.04 Classification of Securities**—The classification of marketable securities as either current assets or noncurrent assets is an important consideration in evaluating their proper carrying amounts. Whether marketable securities are properly classified depends to a large extent on management's intent. If management intends to dispose of the securities in the next fiscal year, the securities are classified as a current asset. Marketable securities that represent an excess of funds available for operations, but which management does not intend to dispose of, are often classified as current assets since management can sell them at any time at their option.

**.05** The auditor should ascertain management's investment objectives to determine whether the securities are properly classified in the financial

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\* See also FASB Statement No. 12 [AC section I89].

statements. He should read the minutes of the board of directors meetings, and he should inquire of the investment committee concerning management's intentions of disposing of the securities. To corroborate management's representation as to its intent, the auditor should consider whether such classification is feasible in light of the company's financial position, working capital requirements, debt agreements, and any other contractual obligations. The client's needs may be such that it is reasonable to presume that the securities will need to be sold to raise operating capital, and consequently should be classified as current assets.

**.06** The auditor should obtain management's representation as to their intent in the client's representation letter. In some circumstances, the classification in the balance sheet should be supplemented by additional information in the notes to the financial statements regarding management's intent to make the financial statements more meaningful to users. The auditor should evaluate the adequacy of disclosures concerning classification of investments in securities and consider the need for such disclosures.

**.07 *Investments Classified as Current Assets.*** Marketable securities, such as stocks and bonds, properly classified as current assets should be written down to market at the balance sheet date to reflect declines that are not temporary in accordance with ARB No. 43, chapter 3A, paragraph 9. When marketable securities classified as a current asset have a market value lower than cost, retention of the cost basis requires persuasive evidence that indicates a recovery in the market value will occur before the earlier of the scheduled maturity or sale date of the securities or within a one-year period from the balance sheet date. Generally, such evidence would be limited to substantial recovery subsequent to the year end. When such evidence does not exist and the client's management carries those securities at cost, the auditor will normally conclude that he does not agree with management's determination of the carrying amount of the securities. Section 508.22 states: "If the auditor, concludes that management's estimate is unreasonable and that its effect is to cause the financial statements to be materially misstated, he should express a qualified or an adverse opinion.

**.08 *Investments Classified as Noncurrent Assets.*** Investments in marketable securities that are properly classified as noncurrent assets should be carried at amounts that result in a fair presentation in conformity with general accepted accounting principles. If there has been a decline in the market value of those investments, the auditor should obtain evidence concerning the nature of the decline. In making that determination, he should consider the ability to ultimately recover the carrying amount of the investments.

**.09** When the market decline is attributable to specific adverse conditions for a particular security, stocks or bonds, a write down in carrying amount is necessary unless persuasive evidence exists to support the carrying amount.

**.10** The value of investments in marketable securities classified as noncurrent assets may decline because of general market conditions that reflect prospects of the economy as a whole or prospects of a particular industry. Such declines may or may not be indicative of the ability to ultimately recover the carrying amount of investments. The auditor should consider all available evidence to evaluate the carrying amount of the securities. For investments in bonds and other investments with fixed maturity amounts, market declines may be considered temporary unless the evidence indicates that such investments will be disposed of before they mature or that they may not be realizable.

.11 If the auditor concludes the available information does not support either a judgment as to eventual recovery or a contrary judgment that recovery will not occur, the continued existence of a decline in market value is indicative of an uncertainty, as described in section 508.23. "In certain instances, however, the outcome of future events that may affect the financial statements, including required disclosures, is not susceptible of reasonable estimation by management. When such uncertainties exist, it cannot be determined whether the financial statements should be adjusted, or in what amount. Such matters are to be regarded as uncertainties for purposes of considering the need for an explanatory paragraph in the auditor's report. In deciding whether to add an explanatory paragraph to his report because of the uncertainty of recovering the carrying amount of the asset, he considers the likelihood of material loss resulting from the resolution of the uncertainty as discussed in section 508.24—.26." The addition of an explanatory paragraph because of the uncertainty of recoverability, however, is not a substitute for recognition of a loss when such recognition is appropriate.

.12 *Reclassifications of Investments.* Management may classify as a noncurrent asset a security that was classified in the previous year's financial statements as a current asset. If the change in classification results from additional experience and information acquired in the current year (see section 420.12), the auditor is not required to add an explanatory paragraph to his report because of the accounting change. For example, management may conclude that the decline in market value will eventually be recovered and decide not to dispose of the security until its market value recovers. If the change in classification is material, the auditor should evaluate the adequacy of the disclosure explaining the change (see section 420.14).

.13 *Unclassified Balance Sheets.* Companies in some industries, such as insurance, investment, finance, and real estate do not present classified balance sheets. The representations made by management in an unclassified balance sheet differ from those made in a classified balance sheet. For example, inclusion of an asset in the current assets section of a classified balance sheet implies that those assets will be, or can be, converted into cash in a specified period. Therefore, if the amount to be realized from converting those assets appears to be impaired, generally accepted accounting principles require that they should be written down to their market values. In an unclassified balance sheet, no representations are made about working capital as of the balance sheet date.

.14 If securities are carried at cost in an unclassified balance sheet, the auditor should consider the operational needs of the company for the foreseeable future. For those securities that will be disposed of in the foreseeable future the auditing considerations are similar to those for marketable securities classified as current assets. For those securities for which there is no evidence indicating that they will be disposed of in the foreseeable future to meet the company's operational needs, the auditing considerations are similar to those discussed for marketable securities classified as noncurrent assets.

[Issue Date: January, 1975.]

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[The next page is 355.]

## AU Section 333

### ***Client Representations***

Source: SAS No. 19.

See section 9333 for interpretations of this section.

Effective for periods ending on or after September 30, 1977, unless otherwise indicated.

.01 This section establishes a requirement that the independent auditor obtain written representations from management as a part of an audit performed in accordance with generally accepted auditing standards and provides guidance concerning the representations to be obtained.

### **Reliance on Management Representations**

.02 During an audit, management makes many representations to the auditor, both oral and written, in response to specific inquiries or through the financial statements. Such representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements. Written representations from management ordinarily confirm oral representations given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations.

.03 The auditor obtains written representations from management to complement his other auditing procedures. In many cases, the auditor applies auditing procedures specifically designed to obtain corroborating information concerning matters that are also the subject of written representations. For example, after the auditor performs the procedures prescribed in section 334, *Related Parties*, even if the results of those procedures indicate that transactions with related parties have been properly disclosed, he should obtain a written representation to document that management has no knowledge of any such transactions that have not been disclosed. In some cases involving written representations, the corroborating information that can be obtained by the application of auditing procedures other than inquiry is limited. When a client plans to discontinue a line of business, for example, the auditor may not be able to obtain information through other auditing procedures to corroborate the plan or intent. Accordingly, the auditor should obtain a written representation to provide confirmation of management's intent.<sup>1</sup> [Reference changed August, 1983, by the issuance of Statement on Auditing Standards No. 45.] (See section 334.)

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<sup>1</sup> See section 316.16, which states: "... The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, the auditor recognizes that conditions observed and evidential matter obtained, including information from prior audits, need to be objectively evaluated to determine whether the financial statements are free of material misstatement."

## Obtaining Written Representations<sup>2</sup>

.04 The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. They ordinarily include the following matters, if applicable:

- a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles or other comprehensive basis of accounting.
- b. Availability of all financial records and related data.
- c. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.
- d. Absence of errors in the financial statements and unrecorded transactions.
- e. Information concerning related party transactions and related amounts receivable or payable.<sup>3</sup>
- f. Noncompliance with aspects of contractual agreements that may affect the financial statements.
- g. Information concerning subsequent events.<sup>4</sup>
- h. Irregularities involving management or employees.<sup>5</sup>
- i. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
- j. Plans or intentions that may affect the carrying value or classification of assets or liabilities.
- k. Disclosure of compensating balance or other arrangements involving restrictions on cash balances, and disclosure of line-of-credit or similar arrangements.
- l. Reduction of excess or obsolete inventories to net realizable value.
- m. Losses from sales commitments.
- n. Satisfactory title to assets, liens on assets, and assets pledged as collateral.
- o. Agreements to repurchase assets previously sold.
- p. Losses from purchase commitments for inventory quantities in excess of requirements or at prices in excess of market.
- q. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.<sup>6</sup>
- r. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].<sup>7</sup>

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<sup>2</sup> An illustrative representation letter from management is contained in the Appendix (section 333A).

<sup>3</sup> See section 334. [Reference changed August, 1983, by the issuance of Statement on Auditing Standards No. 45.]

<sup>4</sup> See sections 560.12 and 711.10. [Reference changed by issuance of Statement on Auditing Standards No. 37.]

<sup>5</sup> See section 316.

<sup>6</sup> See section 317.

<sup>7</sup> See section 337.05.



- s. Unasserted claims or assessments that the client's lawyer has advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59].<sup>8</sup>
- t. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

.05 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on the limits of materiality for this purpose. Such limitations would not apply to those representations that are not directly related to amounts included in the financial statements, for example, items (a), (b), and (c) above. In addition, because of the possible effects of irregularities on other aspects of the audit, a materiality limit would not apply to item (h) above with respect to management and those personnel who have significant roles in the internal control structure.

.06 In addition to matters such as those indicated above, the auditor may determine, based on the circumstances of the engagement, that other matters should be specifically included in written representations from management.<sup>9</sup> For example, if a company excludes a short-term obligation from current liabilities because it intends to refinance the obligation on a long-term basis, the auditor should obtain a specific representation of management's intent to consummate the refinancing.<sup>10</sup> Also, the auditor should obtain written representations concerning interim financial information accompanying audited financial statements. [As modified, May 1981, by the Auditing Standards Board.]

.07 In certain instances, the auditor may request other written representations from management in addition to evidential matter obtained through other procedures. For example, although the auditor may be satisfied with the method of pricing inventories, he may ask management to furnish a representation concerning inventory pricing.

.08 If the independent auditor is reporting on consolidated financial statements, the written representations obtained from the parent company's management should specify that they pertain to the consolidated financial statements and, if applicable, to the separate financial statements of the parent company.

.09 The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his report that may require adjustment to or disclosure in the financial statements, the representations should be dated as of the date of the auditor's report. They should be signed by members of management whom the auditor believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations. Normally, the chief executive officer and chief financial officer should sign the representations.

.10 In certain circumstances, the auditor may want to obtain written representations from other individuals. For example, he may want to obtain

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<sup>8</sup> See section 337.05.

<sup>9</sup> Certain AICPA audit guides require or recommend that the auditor obtain written representations concerning matters that are unique to a particular industry. This section does not supersede those requirements or recommendations.

<sup>10</sup> See Statement of Financial Accounting Standards No. 6, paragraphs 9 through 11 [AC section B05.113].

written representations about the completeness of the minutes of the meetings of stockholders, directors, and committees of directors from the person responsible for keeping such minutes. Also, if the independent auditor performs an audit of the financial statements of a subsidiary but does not audit those of the parent company, he may want to obtain representations from management of the parent company concerning matters that may affect the subsidiary, such as related party transactions or the parent company's intention to provide continuing financial support to the subsidiary.

### **Scope Limitations<sup>11</sup>**

.11 Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion. Further, the auditor should consider the effects of the refusal on his ability to rely on other management representations.

.12 If the auditor is precluded from performing procedures he considers necessary in the circumstances with respect to a matter that is material to the financial statements, even though he has been given representations from management concerning the matter, there is a limitation on the scope of his audit, and he should qualify his opinion or disclaim an opinion.

### **Effective Date**

.13 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this section provides for practices that may differ in certain respects from practices heretofore considered acceptable, this section will be effective for audits made in accordance with generally accepted auditing standards for periods ending on or after September 30, 1977.

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<sup>11</sup> See section 508.40—48.

**AU Section 333A****Appendix—Illustrative  
Representation  
Letter**

**Source: SAS No. 19.**

.01 The following letter is presented for illustrative purposes only. The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being audited. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, 19X1 and 19X0, and the related statements of income and retained earnings and cash flows for the years then ended." Similarly, representations concerning inventories and sales and purchase commitments would not be obtained if such items are not material to the company's financial position and results of operations or if they are not recorded in the financial statements under a comprehensive basis of accounting other than generally accepted accounting principles, for example, financial statements prepared on the cash basis of accounting.

.02 The illustrative letter assumes that there are no matters requiring specific disclosure to the auditor. If such matters exist, they should be indicated by listing them following the representation, by reference to accounting records or financial statements, or by other similar means. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, item 14 could be modified as follows: "Except as discussed in Note X to the financial statements, no events have occurred. . . ." Similarly, in appropriate circumstances, item 4 could be modified as follows: "We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except that certain marketable securities have been excluded from current assets based on our intention not to dispose of them, which is supported by the minutes of the December 7, 19X1, meeting of the board of directors."

.03 Certain terms are used in the illustrative letter that are defined elsewhere in authoritative literature, for example, irregularities (section 316) and related parties (section 334.01, footnote 1). To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to the client and request that the client include the definitions in the written representations. [Reference changed August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 334.)

.04 The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in section 333.05.

.05

(Date of Auditor's Report)

(To Independent Auditor)

In connection with your audit of the (identification of financial statements) of (name of client) as of (date) and for the (period of examination) for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles (other comprehensive basis of accounting), we confirm, to the best of our knowledge and belief, the following representations made to you during your audit.

1. We are responsible for the fair presentation in the (consolidated) financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (other comprehensive basis of accounting).
2. We have made available to you all—
  - a. Financial records and related data.
  - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no—
  - a. Irregularities involving management or employees who have significant roles in the internal control structure.
  - b. Irregularities involving other employees that could have a material effect on the financial statements.
  - c. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.
4. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
5. The following have been properly recorded or disclosed in the financial statements:
  - a. Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.
  - b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.
  - c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.
  - d. Agreements to repurchase assets previously sold.
6. There are no—
  - a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

- b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].
- 7. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59].
- 8. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
- 9. Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.
- 10. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.
- 11. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.
- 12. Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.
- 13. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
- 14. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

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(Name of Chief Executive  
Officer and Title)

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(Name of Chief Financial  
Officer and Title)

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[The next page is 365.]

**AU Section 9333*****Client Representations:  
Auditing Interpretations  
of Section 333*****1. Management Representations on Violations and Possible Violations of Laws and Regulations**

.01 *Question*—Section 333, *Client Representations*, lists matters for which the auditor ordinarily obtains written representations from management. One of those matters is: Violations or possible violations of laws or regulations whose effects should be considered for disclosure in financial statements or as a basis for recording a loss contingency.

.02 Guidance on evaluating the need to disclose litigation, claims, and assessments that may result from possible violations is provided by FASB Statement No. 5 [AC section C59], *Accounting for Contingencies*. Section 317, *Illegal Acts by Clients*, provides guidance on evaluating the materiality of illegal acts. Does the representation regarding “possible violations” include matters beyond those described in FASB Statement No. 5 [AC section C59] and section 317?

.03 *Interpretation*—No. Section 333 did not change the relevant criteria for evaluating the need for disclosure of violations and possible violations of laws or regulations. In requesting the representation on possible violations, the auditor is not asking for management’s speculation on all possibilities of legal challenges to its actions.

.04 The representation concerns matters that have come to management’s attention and that are significant enough that they should be considered in determining whether financial statement disclosures are necessary. It recognizes that these are matters of judgment and that the need for disclosure is not always readily apparent.

[Issue Date: March, 1979.]

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[The next page is 367.]

## AU Section 334

### **Related Parties**

*(Supersedes Statement on Auditing Standards*

*No. 6, AICPA, Professional Standards,*

*vol. 1, AU sec. 335.01—19)\**

Source: SAS No. 45.

See section 9334 for interpretations of this section.

Effective for periods ended after September 30, 1983, unless otherwise indicated.

.01 This section provides guidance on procedures that should be considered by the auditor when he is performing an audit of financial statements in accordance with generally accepted auditing standards to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure.<sup>1</sup> The procedures set forth in this section should not be considered all-inclusive. Also, not all of them may be required in every audit.

### **Accounting Considerations**

.02 FASB Statement No. 57 [AC section R36], *Related Party Disclosures*, gives the requirements for related party disclosures. Certain accounting pronouncements prescribe the accounting treatment when related parties are involved; however, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. The auditor should view related party transactions within the framework of existing

\* This section also withdraws the following auditing interpretations dated March 1976 (AICPA, *Professional Standards*, vol. 1, AU sec. 9335.01—11):

- Evaluating the Adequacy of Disclosure of Related Party Transactions
- Disclosure of Commonly Controlled Parties
- Definition of "Immediate Family"

<sup>1</sup> Financial Accounting Standards Board Statement No. 57, *Related Party Disclosures*, paragraphs 2 through 4 [AC section R36.102—104], contains the disclosure requirements for related party relationships and transactions. The glossary of that Statement [AC section R36.406] defines related parties as follows:

Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

The glossary also gives definitions of the terms "affiliate," "control," "immediate family," "management," and "principal owners" [AC section R36.401—405]. Paragraph 1 of the FASB Statement [AC section R36.101] gives examples of related party transactions.

pronouncements, placing primary emphasis on the adequacy of disclosure. In addition, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form.<sup>2</sup>

.03 Transactions that because of their nature may be indicative of the existence of related parties include<sup>3</sup>—

- a. Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
- b. Selling real estate at a price that differs significantly from its appraised value.
- c. Exchanging property for similar property in a nonmonetary transaction.
- d. Making loans with no scheduled terms for when or how the funds will be repaid.

## Audit Procedures

.04 An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Nevertheless, during the course of his audit, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships for which FASB Statement No. 57 [AC section R36] requires disclosure even though there are no transactions. Many of the procedures outlined in the following paragraphs are normally performed in an audit in accordance with generally accepted auditing standards, even if the auditor has no reason to suspect that related party transactions or control relationships exist. Other audit procedures set forth in this section are specifically directed to related party transactions.

.05 In determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component to the total entity. He should consider internal control structure policies and procedures over management activities, and he should consider the business purpose served by the various components of the entity. Normally, the business structure and style of operating are based on the abilities of management, tax and legal considerations, product diversification, and geographical location. Experience has shown, however, that business structure

<sup>2</sup> Accounting Principles Board Statement No. 4, paragraph 35, states, "Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form." Other pronouncements specify criteria for determining, presenting, and accounting for the substance of certain transactions and events. Examples include (1) presenting consolidated financial statements instead of separate statements of the component legal entities (Accounting Research Bulletin No. 51 [AC section C51]); (2) capitalizing leases (FASB Statement No. 13 [AC section L10]); and (3) imputing an appropriate interest rate when the face amount of a note does not reasonably represent the present value of the consideration given or received in exchange for it (Accounting Principles Board Opinion No. 21 [AC section I69]; FASB Statement No. 94 [AC section C51]).

<sup>3</sup> FASB Statement No. 57, paragraph 1 [AC section R36.101], gives other examples of common types of transactions with related parties, and it states that "transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition."



and operating style are occasionally deliberately designed to obscure related party transactions.

**.06** In the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business. The auditor should, however, be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar to the following:

- a* Lack of sufficient working capital or credit to continue the business
- b* An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock
- c* An overly optimistic earnings forecast
- d* Dependence on a single or relatively few products, customers, or transactions for the continuing success of the venture
- e* A declining industry characterized by a large number of business failures
- f* Excess capacity
- g* Significant litigation, especially litigation between stockholders and management
- h* Significant obsolescence dangers because the company is in a high-technology industry

### **Determining the Existence of Related Parties**

**.07** The auditor should place emphasis on testing material transactions with parties he knows are related to the reporting entity. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of specific audit procedures, which may include the following:

- a* Evaluate the company's procedures for identifying and properly accounting for related party transactions.
- b* Request from appropriate management personnel the names of all related parties and inquire whether there were any transactions with these parties during the period.
- c* Review filings by the reporting entity with the Securities and Exchange Commission and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.
- d* Determine the names of all pension and other trusts established for the benefit of employees and the names of their officers and trustees.<sup>4</sup>
- e* Review stockholder listings of closely held companies to identify principal stockholders.
- f* Review prior years' working papers for the names of known related parties.
- g* Inquire of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.

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<sup>4</sup> According to FASB Statement No. 57, paragraph 24(f) [AC section R36.406] "trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management," are related parties.

- h. Review material investment transactions during the period under audit to determine whether the nature and extent of investments during the period create related parties.

### Identifying Transactions With Related Parties

.08 The following procedures are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

- a. Provide audit personnel performing segments of the audit or auditing and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their audits.
- b. Review the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorized or discussed at their meetings.
- c. Review proxy and other material filed with the Securities and Exchange Commission and comparable data filed with other regulatory agencies for information about material transactions with related parties.
- d. Review conflict-of-interests statements obtained by the company from its management.<sup>5</sup>
- e. Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships.
- f. Consider whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management or other services at no charge or a major stockholder absorbing corporate expenses.
- g. Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
- h. Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
- i. Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.
- j. Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

### Examining Identified Related Party Transactions

.09 After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the

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<sup>5</sup> Conflict-of-interests statements are intended to provide the board of directors with information about the existence or nonexistence of relationships between the reporting persons and parties with whom the company transacts business.

purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management. Procedures that should be considered include the following:

- a. Obtain an understanding of the business purpose of the transaction.<sup>6</sup>
- b. Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents.
- c. Determine whether the transaction has been approved by the board of directors or other appropriate officials.
- d. Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.
- e. Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.
- f. Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

.10 When necessary to fully understand a particular transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered.<sup>7</sup>

- a. Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.
- b. Inspect evidence in possession of the other party or parties to the transaction.
- c. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
- d. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
- e. With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

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<sup>6</sup> Until the auditor understands the business sense of material transactions, he cannot complete his audit. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge.

<sup>7</sup> Arrangements for certain procedures should be made or approved in advance by appropriate client officials.

**Disclosure**

.11 For each material related party transaction (or aggregation of similar transactions) or common ownership or management control relationship for which FASB Statement No. 57 [AC section R36] requires disclosure, the auditor should consider whether he has obtained sufficient competent evidential matter to understand the relationship of the parties and, for related party transactions, the effects of the transaction on the financial statements. He should then evaluate all the information available to him concerning the related party transaction or control relationship and satisfy himself on the basis of his professional judgment that it is adequately disclosed in the financial statements.<sup>8</sup>

.12 Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions.<sup>9</sup> If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality (see section 508.49 and .50).

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[The next page is 367-11.]

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<sup>8</sup> The disclosure standards are contained in FASB Statement No. 57, paragraphs 2 through 4 [AC section R36.102—.104]. Also, see section 431, *Adequacy of Disclosure in Financial Statements*.

<sup>9</sup> FASB Statement No. 57, paragraph 3 [AC section R36.103], states that if representations are made about transactions with related parties, the representations "shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated."

## AU Section 9334\*

### ***Related Parties: Auditing Interpretations of Section 334***

#### **[1.] Evaluating the Adequacy of Disclosure of Related Party Transactions**

[.01-.05] [Withdrawn August, 1983, by SAS No. 45.] (See section 334.)

#### **[2.] Disclosure of Commonly Controlled Parties**

[.06-.09] [Withdrawn August, 1983, by SAS No. 45.] (See Section 334.)

#### **[3.] Definition of "Immediate Family"**

[.10-.11] [Withdrawn August, 1983, by SAS No. 45.] (See section 334.)

#### **4. Exchange of Information Between the Principal and Other Auditor on Related Parties**

**.12 Question**—Section 334, *Related Parties*, paragraphs .04 and .07, states that "during the course of his audit, the auditor should be aware of the possible existence of material related party transactions," and that determining the existence of related party transactions may require the inquiry of the "principal, or other auditors of related entities as to their knowledge of existing relationships and the extent of management involvement in material transactions." When should that inquiry be made? [Reference changed August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 334.)

**.13 Interpretation**—The principal auditor and the other auditor should each obtain from the other the names of known related parties and the other information referred to above. Ordinarily, that exchange of information should be made at an early stage of the audit.

[Issue Date: April, 1979.]

#### **5. Examination of Identified Related Party Transactions with a Component**

**.14 Question**—According to section 334.09, once related party transactions have been identified, "the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature and extent of these transactions and their effect on the financial statements." When there is a principal auditor-other auditor relationship, how may the auditors obtain that satisfaction regarding transactions that may involve not only the components<sup>1</sup> they are examining, but also, other components? [Reference changed August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 334.)

**.15 Interpretation**—Audit procedures may sometimes have to be applied to records of components being examined by the other. One auditor may

\* [Section number changed August, 1983, to correspond to section 334, *Related Parties*.]

<sup>1</sup> For the purpose of this interpretation, the entities whose separate financial statements collectively comprise the consolidated or other financial statements are referred to as components.

arrange to perform those procedures himself, or he may request the other to do so.<sup>2</sup> There may be circumstances when there are unusual or complex related party transactions and an auditor believes that access to relevant portions of the other's work papers is essential to his understanding of the effects of those transactions on the financial statements he is auditing. In those circumstances, access ordinarily should be provided.<sup>3</sup>

[Issue Date: April, 1979.]

## 6. The Nature and Extent of Auditing Procedures for Examining Related Party Transactions

**.16 Question**—Section 334, *Related Parties*, provides general guidance about the types of procedures an auditor might apply to identified related party transactions. How extensive should the auditor's procedures be to examine related party transactions?

**.17 Interpretation**—The auditor's procedures should be sufficient to provide reasonable assurance that related party transactions are adequately disclosed and that identified related party transactions do not contain misstatements that, when aggregated with misstatements in other balances or classes of transactions, could be material to the financial statements taken as a whole. As in examining any other material account balance or class of transactions, the auditor needs to consider audit risk<sup>4</sup> and design and apply appropriate substantive tests to evaluate management's assertions.

**.18** The risk associated with management's assertions about related party transactions is often assessed as higher than for many other types of transactions because of the possibility that the parties to the transaction are motivated by reasons other than those that exist for most business transactions.<sup>5</sup>

**.19** The higher the auditor's assessment of risk regarding related party transactions, the more extensive or effective the audit tests should be. For example, the auditor's tests regarding valuation of a receivable from an entity under common control might be more extensive than for a trade receivable of the same size because the common parent may be motivated to obscure the substance of the transaction. In assessing the risk of the related party transactions the auditor obtains an understanding of the business purpose of the transactions. Until the auditor understands the business sense of material transactions, he cannot complete his audit. If he lacks sufficient specialized knowledge to obtain that understanding for a particular transaction, he should consult with persons who do have the requisite knowledge. In addition, to understand the transaction, or obtain evidence regarding it, the auditor may have to refer to audited or unaudited financial statements of the related party, apply procedures at the related party, or in some cases audit the financial statements of the related party.

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<sup>2</sup> In this case, the auditor should follow the guidance in the interpretation titled *Specific Procedures Performed by Other Auditors at the Principal Auditor's Request*, section 9543.01-.03.

<sup>3</sup> There is no intention in this interpretation to modify section 543.12c regarding the principal auditor's consideration of review of the other auditor's workpapers when he decides not to make reference to the other auditor.

<sup>4</sup> Audit risk and its components are described in section 312, *Audit Risk and Materiality in Conducting an Audit*.

<sup>5</sup> See section 334.06.

**.20 Question**—Section 334, *Related Parties*, paragraph .07, states that specific audit procedures should be applied to determine if related parties exist. That paragraph also suggests some specific audit procedures to identify related parties that the auditor should consider. What other audit procedures for determining the existence of related parties should the auditor consider?

**.21 Interpretation**—The auditor should consider obtaining representations from the entity's senior management and its board of directors about whether they or any other related parties engaged in any transactions with the entity during the period.

[Issue Date: May, 1986.]

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[The next page is 371.]

## AU Section 336

### ***Using the Work of a Specialist***

Source: SAS No. 11.

See section 9336 for interpretations of this section.

Issue date, unless otherwise indicated: December, 1975.

.01 The purpose of this section is to provide guidance to the auditor who uses the work of a specialist in performing an audit of financial statements in accordance with generally accepted auditing standards.<sup>1</sup> For purposes of this section, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. Examples of such specialists include actuaries, appraisers, attorneys, engineers, and geologists.<sup>2</sup>

#### **Decision to Use the Work of a Specialist**

.02 The auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. During his audit, however, an auditor may encounter matters potentially material to the fair presentation of financial statements in conformity with generally accepted accounting principles that require special knowledge and that in his judgment require using the work of a specialist.

.03 Examples of the types of matters that the auditor may decide require him to consider using the work of a specialist include, but are not limited to, the following:

- a. Valuation (e.g., works of art, special drugs, and restricted securities).
- b. Determination of physical characteristics relating to quantity on hand or condition (e.g., mineral reserves or materials stored in piles above ground).
- c. Determination of amounts derived by using specialized techniques or methods (e.g., certain actuarial determinations).
- d. Interpretation of technical requirements, regulations, or agreements (e.g., the potential significance of contracts or other legal documents, or legal title to property).

.04 In performing an audit of financial statements in accordance with generally accepted auditing standards, the auditor may use the work of a specialist as an audit procedure to obtain competent evidential matter. The

<sup>1</sup> This section does not apply to using the work of a specialist who is a member of the auditor's staff, or to the form or content of letters of audit inquiry concerning litigation, claims, or assessments and lawyers' responses thereto.

<sup>2</sup> For purposes of this section, a person whose special skill or knowledge relates to the internal affairs or business practices of the client, such as a credit or plant manager, is not considered a specialist.



circumstances surrounding the use of a specialist differ. Although the familiarity of individual auditors with the work performed by certain types of specialists may differ, the auditing procedures necessary to comply with generally accepted auditing standards need not vary as a result of the extent of the auditor's knowledge.

## Selecting a Specialist

**.05** The auditor should satisfy himself concerning the professional qualifications and reputation of the specialist by inquiry or other procedures, as appropriate. The auditor should consider the following:

- a. The professional certification, license, or other recognition of the competence of the specialist in his field, as appropriate.
- b. The reputation and standing of the specialist in the views of his peers and others familiar with his capability or performance.
- c. The relationship, if any, of the specialist to the client.

**.06** Ordinarily, the auditor should attempt to obtain a specialist who is unrelated to the client. However, when the circumstances so warrant, work of a specialist having a relationship to the client may be acceptable (see paragraph .08). Work of a specialist unrelated to the client will usually provide the auditor with greater assurance of reliability because of the absence of a relationship that might impair objectivity.

**.07** An understanding should exist among the auditor, the client, and the specialist as to the nature of the work to be performed by the specialist. Preferably, the understanding should be documented and should cover the following:

- a. The objectives and scope of the specialist's work.
- b. The specialist's representations as to his relationship, if any, to the client.
- c. The methods or assumptions to be used.
- d. A comparison of the methods or assumptions to be used with those used in the preceding period.
- e. The specialist's understanding of the auditor's corroborative use of the specialist's findings in relation to the representations in the financial statements.
- f. The form and content of the specialist's report that would enable the auditor to make the evaluation described in paragraph .08.

## Using the Findings of the Specialist

**.08** Although the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings are suitable for corroborating the representations in the financial statements. The auditor should consider whether the specialist's findings support the related representations in the financial statements and make appropriate tests of accounting data provided by the client to the specialist. Ordinarily, the auditor would use the work of the specialist unless his procedures lead him to believe that the findings are unreasonable in the circumstances. If the specialist is related to the client (see paragraph .06), the auditor should consider performing additional procedures with respect to some or all of the related specialist's assump-

tions, methods, or findings to determine that the findings are not unreasonable or engage an outside specialist for that purpose.

## **Effect of the Specialist's Work on the Auditor's Report**

.09 If the auditor determines that the specialist's findings support the related representations in the financial statements, he may reasonably conclude that he has obtained sufficient competent evidential matter. If there is a material difference between the specialist's findings and the representations in the financial statements, or if the auditor believes that the determinations made by the specialist are unreasonable, he should apply additional procedures. If after applying any additional procedures that might be appropriate he is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved will ordinarily cause the auditor to conclude that he should qualify his opinion or disclaim an opinion because the inability to obtain sufficient competent evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation (see section 508.40—.41).

.10 The auditor may conclude after performing additional procedures, including possibly obtaining the opinion of another specialist, that the representations in the financial statements are not in conformity with generally accepted accounting principles. In that event, he should express a qualified or adverse opinion (see section 508.49—.50 and .55).

## **Reference to the Specialist in the Auditor's Report**

.11 When expressing an unqualified opinion, the auditor should not refer to the work or findings of the specialist. Such a reference in an unqualified opinion might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.

.12 If the auditor, as a result of the report or findings of the specialist (see paragraphs .09 and .10), decides to: 1) add an explanatory paragraph describing an uncertainty, 2) add an explanatory paragraph describing his or her substantial doubt about the entity's ability to continue as a going concern, 3) add an explanatory paragraph to emphasize a matter regarding the financial statements, or 4) depart from an unqualified opinion, reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion. [Paragraph amended to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

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[The next page is 375.]

**AU Section 9336*****Using the Work of a Specialist: Auditing Interpretations of Section 336*****1. Applicability of Guidance on the Use of Specialists**

**.01 Question**—Management may engage or employ a specialist to prepare, or assist in the preparation of, amounts or disclosures in the financial statements. If that amount or disclosure is material to the financial statements, is the guidance in section 336, *Using the Work of a Specialist*, applicable when performing an audit of the financial statements in accordance with generally accepted auditing standards?

**.02 Interpretation**—Yes. Section 336 states, “During his audit . . . an auditor may encounter matters potentially material to the fair presentation of financial statements in conformity with generally accepted accounting principles that require special knowledge and that in his judgment require using the work of a specialist.” When a specialist has prepared, or assisted in the preparation of, a matter that is potentially material to the financial statements, if the auditor intends to use that specialist’s work as evidential matter, he should follow the guidance in section 336.

**.03** Thus, as with any specialist whose work the auditor uses, the auditor should satisfy himself as to the professional qualifications and reputation of the specialist, obtain an understanding of the specialist’s methods and assumptions, test accounting data provided to the specialist, and consider whether the specialist’s findings support the related representations in the financial statements.

[Issue Date: October, 1979.]

**2. Exclusion of Specialists on the Audit Staff**

**.04 Question**—Section 336, *Using the Work of a Specialist*, in footnote 1 states, “This statement does not apply to using the work of a specialist who is a member of the auditor’s staff. . . .” Does this mean that section 336, does not apply when a specialist with an auditor’s firm provides advisory services to a client?

**.05 Interpretation**—No. The exclusion in section 336 only relates to specialists serving as members of the audit staff, that is, those who participate in the audit. For example, statisticians may assist in the execution of audit sampling plans or computer specialists may assist in the audits of financial statements of clients with complex EDP operations. However, some CPA firms have specialists who provide advisory services in addition to participating in an audit. The exclusion applies only to a specialist’s participation in the audit. When a specialist with the auditor’s firm provides advisory services to a client and the auditor decides to use that specialist’s work as evidential matter, he should follow the guidance in section 336.

[Issue Date: October, 1979.]

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[The next page is 381.]

**AU Section 337*****Inquiry of a Client's Lawyer Concerning  
Litigation, Claims,  
and Assessments<sup>1</sup>***

Source: SAS No. 12.

See section 9337 for interpretations of this section.

Issue date, unless otherwise indicated: January, 1976.

.01 This section provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters when he is performing an audit in accordance with generally accepted auditing standards.

**Accounting Considerations**

.02 Management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements in conformity with generally accepted accounting principles.

.03 The standards of financial accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments, are set forth in Statement of Financial Accounting Standards No. 5 [AC section C59], *Accounting for Contingencies*.<sup>2</sup>

**Auditing Considerations**

.04 With respect to litigation, claims, and assessments, the independent auditor should obtain evidential matter relevant to the following factors:

- a. The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments.
- b. The period in which the underlying cause for legal action occurred.
- c. The degree of probability of an unfavorable outcome.
- d. The amount or range of potential loss.

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<sup>1</sup> This section supersedes the commentary, "Lawyers' Letters," January 1974 (section 1001), and auditing interpretations of section 560.12 on lawyers' letters, January 1975 (section 9560.01—.26). It amends section 560.12(d) to read as follows: "Inquire of client's legal counsel concerning litigation, claims, and assessments (see section 337)."

<sup>2</sup> Pertinent portions are reprinted in Exhibit I, section 337B. FASB Statement No. 5 [AC section C59], also describes the standards of financial accounting and reporting for gain contingencies. The auditor's procedures with respect to gain contingencies are parallel to those described in this SAS for loss contingencies.

## Audit Procedures

.05 Since the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

- a. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- b. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].
- c. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.
- d. Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59]. Also the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.<sup>3</sup>

.06 An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention. Accordingly, the auditor should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.07 The audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Examples of such procedures are as follows:

- a. Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited.
- b. Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents.
- c. Obtaining information concerning guarantees from bank confirmation forms.

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<sup>3</sup> An example of a separate letter is as follows: We are writing to inform you that (name of company) has represented to us that (except as set forth below and excluding any such matters listed in the letter of audit inquiry) there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59] in its financial statements at (balance sheet date) and for the (period) then ended. (List unasserted possible claims, if any.) Such a letter should be signed and sent by the auditor.

- d. Inspecting other documents for possible guarantees by the client.

### **Inquiry of a Client's Lawyer <sup>4</sup>**

.08 A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.<sup>5</sup> Evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration. However, evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish.

.09 The matters that should be covered in a letter of audit inquiry include, but are not limited to, the following:

- a. Identification of the company, including subsidiaries, and the date of the audit.
- b. A list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.
- c. A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.
- d. As to each matter listed in item b, a request that the lawyer either furnish the following information or comment on those matters as to which his views may differ from those stated by management, as appropriate:
  - (1) A description of the nature of the matter, the progress of the case to date, and the action the company intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement).
  - (2) An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.
  - (3) With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.
- e. As to each matter listed in item c, a request that the lawyer comment on those matters as to which his views concerning the description or evaluation of the matter may differ from those stated by management.

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<sup>4</sup> An illustrative inquiry letter to legal counsel is contained in the Appendix (section 337A).

<sup>5</sup> It is not intended that the lawyer be requested to undertake a reconsideration of all matters upon which he was consulted during the period under audit for the purpose of determining whether he can form a conclusion regarding the probability of assertion of any possible claim inherent in any of the matters so considered.

- f. A statement by the client that the client understands that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client should disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [AC section C59].
- g. A request that the lawyer confirm whether the understanding described in item f is correct.
- h. A request that the lawyer specifically identify the nature of and reasons for any limitation on his response.

Inquiry need not be made concerning matters that are not considered material, provided the client and the auditor have reached an understanding on the limits of materiality for this purpose.

.10 In special circumstances, the auditor may obtain a response concerning matters covered by the audit inquiry letter in a conference, which offers an opportunity for a more detailed discussion and explanation than a written reply. A conference may be appropriate when the evaluation of the need for accounting for or disclosure of litigation, claims, and assessments involves such matters as the evaluation of the effect of legal advice concerning unsettled points of law, the effect of uncorroborated information, or other complex judgments. The auditor should appropriately document conclusions reached concerning the need for accounting for or disclosure of litigation, claims, and assessments.

.11 In some circumstances, a lawyer may be required by his Code of Professional Responsibility to resign his engagement if his advice concerning financial accounting and reporting for litigation, claims, and assessments is disregarded by the client. When the auditor is aware that a client has changed lawyers or that a lawyer engaged by the client has resigned, the auditor should consider the need for inquiries concerning the reasons the lawyer is no longer associated with the client.

### **Limitations on the Scope of a Lawyer's Response <sup>6</sup>**

.12 A lawyer may appropriately limit his response to matters to which he has given substantive attention in the form of legal consultation or representation. Also, a lawyer's response may be limited to matters that are considered individually or collectively material to the financial statements, provided the lawyer and auditor have reached an understanding on the limits of materiality for this purpose. Such limitations are not limitations on the scope of the audit.

.13 A lawyer's refusal to furnish the information requested in an inquiry letter either in writing or orally (see paragraphs .09 and .10) would be a limitation on the scope of the audit sufficient to preclude an unqualified

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<sup>6</sup> The American Bar Association has approved a "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," which explains the concerns of lawyers and the nature of the limitations an auditor is likely to encounter. That Statement of Policy is reprinted as Exhibit II (section 337C) for the convenience of readers, but is not an integral part of this Statement.

opinion (see section 508.40—.41).<sup>7</sup> A lawyer's response to such an inquiry and the procedures set forth in paragraph .05 provide the auditor with sufficient evidential matter to satisfy himself concerning the accounting for and reporting of pending and threatened litigation, claims and assessments. The auditor obtains sufficient evidential matter to satisfy himself concerning reporting for those unasserted claims and assessments required to be disclosed in financial statements from the foregoing procedures and the lawyer's specific acknowledgement of his responsibility to his client in respect of disclosure obligations (see paragraph .09g). This approach with respect to unasserted claims and assessments is necessitated by the public interest in protecting the confidentiality of lawyer-client communications.

### **Other Limitations on a Lawyer's Response**

.14 A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation. If the effect of the matter on the financial statements could be material, the auditor will ordinarily conclude that an explanatory paragraph should be added to his report because of the matter involving an uncertainty (see section 508.16—.30).

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[The next page is 389.]

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<sup>7</sup> A refusal to respond should be distinguished from an inability to form a conclusion with respect to certain matters of judgment (see paragraph .14). Also, lawyers outside the United States sometimes follow practices at variance with those contemplated by this section to the extent that different procedures from those outlined herein may be necessary. In such circumstances, the auditor should exercise judgment in determining whether alternative procedures are adequate to comply with the requirements of this section.



**AU Section 337A****Appendix—Illustrative  
Audit Inquiry Letter to  
Legal Counsel**

Source: SAS No. 12.

Issue date, unless otherwise indicated: January, 1976.

.01 In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

*Pending or Threatened Litigation (excluding unasserted claims)*

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

*Unasserted Claims and Assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)*

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you

have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

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## AU Section 337B

# ***Exhibit I—Excerpts from Statement of Financial Accounting Standards No. 5: Accounting for Contingencies***

Source: SAS No. 12.

March, 1975.

*The following excerpts are reprinted with the permission of the Financial Accounting Standards Board.*

### **Introduction**

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a “gain contingency”) or loss<sup>1</sup> (hereinafter a “loss contingency”) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. . . .

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

- a) *Probable*. The future event or events are likely to occur.
- b) *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
- c) *Remote*. The chance of the future event or events occurring is slight. . . .

### **Standards of Financial Accounting and Reporting**

#### **Accrual of Loss Contingencies**

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income<sup>3</sup> if *both* of the following conditions are met:

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<sup>1</sup> The term *loss* is used for convenience to include many charges against income that are commonly referred to as *expenses* and others that are commonly referred to as *losses*.

<sup>3</sup> [Superseded, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.]

a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.<sup>4</sup> It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b) The amount of loss can be reasonably estimated.

### Disclosure of Loss Contingencies

9. Disclosure of the nature of an accrual<sup>5</sup> made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.<sup>6</sup> The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

11. After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 8(a) is, therefore, not met. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of asset impairment or liability incurrence can be reasonably estimated, disclo-

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<sup>4</sup> *Date of the financial statements* means the end of the most recent accounting period for which financial statements are being presented.

<sup>5</sup> Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57—64 of *Accounting Terminology Bulletin No. 1*, "Review and Resume").

<sup>6</sup> For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements.

sure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements. . . .

### **Litigation, Claims, and Assessments**

33. The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

- a) The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.
- b) The degree of probability of an unfavorable outcome.
- c) The ability to make a reasonable estimate of the amount of loss.

34. As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued, for example, a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. Disclosure may be required, however, by paragraph 11.

35. On the other hand, accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an enterprise's financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued, accrual of a loss related to the litigation, claim, or assessment would be required if the probability of loss is such that the condition in paragraph 8(a) is met and the amount of loss can be reasonably estimated.

36. If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

37. The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is

determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement.

38. With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10.

39. As a condition for accrual of a loss contingency, paragraph 8(b) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 8(a)), but the range of possible loss is wide. For example, an enterprise may be litigating an income tax matter. In preparation for the trial, it may determine that, based on recent decisions involving one aspect of the litigation, it is probable that it will have to pay additional taxes of \$2 million. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay taxes of \$8 million over and above the \$2 million. In that case, paragraph 8 requires accrual of the \$2 million if that is considered a reasonable estimate of the loss. Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that additional taxes will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the \$2 million that was accrued.

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[The next page is 397.]

**AU Section 337C*****Exhibit II—American Bar  
Association Statement of  
Policy Regarding Lawyers’  
Responses to Auditors’  
Requests for Information***

Source: SAS No. 12.

**Preamble**

The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the “confidentiality” essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client’s ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

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**NOTE:** This document, in the form herein set forth, was approved by the Board of Governors of the American Bar Association in December 1975, which official action permitted its release to lawyers and accountants as the standard recommended by the American Bar Association for the lawyer’s response to letters of audit inquiry.

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g., denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

It is recognized that the disclosure requirements for enterprises subject to the reporting requirements of the Federal securities laws are a major concern of managements and counsel, as well as auditors. It is submitted that compliance therewith is best assured when clients are afforded maximum encouragement, by protecting lawyer-client confidentiality, freely to consult counsel. Likewise, lawyers must be keenly conscious of the importance of their clients being competently advised in these matters.

## Statement of Policy

NOW, THEREFORE, BE IT RESOLVED that it is desirable and in the public interest that this Association adopt the following Statement of Policy regarding the appropriate scope of the lawyer's response to the auditor's request, made by the client at the request of the auditor, for information concerning matters referred to the lawyer during the course of his representation of the client:

(1) *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying Commentary), to the extent hereinafter set forth, subject to the following:

(a) Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.

(b) In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the



evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.

(c) Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.

(d) In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

(2) *Limitation on Scope of Response.* It is appropriate for the lawyer to set forth in his response, by way of limitation, the scope of his engagement by the client. It is also appropriate for the lawyer to indicate the date as of which information is furnished and to disclaim any undertaking to advise the auditor of changes which may thereafter be brought to the lawyer's attention. *Unless the lawyer's response indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon, and (b) if a law firm or a law department, the auditor may assume that the firm or department has endeavored, to the extent believed necessary by the firm or department, to determine from lawyers currently in the firm or department who have performed services for the client since the beginning of the fiscal period under audit whether such services involved substantive attention in the form of legal consultation concerning those loss contingencies referred to in Paragraph 5(a) below but, beyond that, no review has been made of any of the client's transactions or other matters for the purpose of identifying loss contingencies to be described in the response.\**

(3) *Response may be Limited to Material Items.* In response to an auditor's request for disclosure of loss contingencies of a client, it is appropriate for the lawyer's response to indicate that the response is limited to items which are considered individually or collectively material to the presentation of the client's financial statements.

(4) *Limited Responses.* Where the lawyer is limiting his response in accordance with the Statement of Policy, his response should so indicate (see Paragraph 8). If in any other respect the lawyer is not undertaking to respond to or comment on particular aspects of the inquiry when responding to the auditor, he should consider advising the auditor that his response is limited, in order to avoid any inference that the lawyer has responded to all aspects; otherwise, he may be assuming a responsibility which he does not intend.

(5) *Loss Contingencies.* When properly requested by the client, it is appropriate for the lawyer to furnish to the auditor information concerning the following matters if the lawyer has been engaged by the client to represent or advise the client professionally with respect thereto and he has devoted substantive attention to them in the form of legal representation or consultation:

(a) *overtly threatened or pending litigation*, whether or not specified by the client;

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\* As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

(b) *a contractually assumed obligation* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor;

(c) *an unasserted possible claim or assessment* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.

With respect to clause (a), overtly threatened litigation means that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote. With respect to clause (c), where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment, consistent with the considerations and concerns outlined in the Preamble and Paragraph 1 hereof, the client should request the lawyer to furnish information to the auditor only if the client has determined that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable, and that the resulting liability would be material to the financial condition of the client. Examples of such situations might (depending in each case upon the particular circumstances) include the following: (i) a catastrophe, accident or other similar physical occurrence in which the client's involvement is open and notorious, or (ii) an investigation by a government agency where enforcement proceedings have been instituted or where the likelihood that they will not be instituted is remote, under circumstances where assertion of one or more private claims for redress would normally be expected, or (iii) a public disclosure by the client acknowledging (and thus focusing attention upon) the existence of one or more probable claims arising out of an event or circumstance. In assessing whether or not the assertion of a possible claim is probable, it is expected that the client would normally employ, by reason of the inherent uncertainties involved and insufficiency of available data, concepts parallel to those used by the lawyer (discussed below) in assessing whether or not an unfavorable outcome is probable; thus, assertion of a possible claim would be considered probable only when the prospects of its being asserted seem reasonably certain (i.e., supported by extrinsic evidence strong enough to establish a presumption that it will happen) and the prospects of nonassertion seem slight.

It would not be appropriate, however, for the lawyer to be requested to furnish information in response to an inquiry letter or supplement thereto if it appears that (a) the client has been required to specify unasserted possible claims without regard to the standard suggested in the preceding paragraph, or (b) the client has been required to specify all or substantially all unasserted possible claims as to which legal advice may have been obtained, since, in either case, such a request would be in substance a general inquiry and would be inconsistent with the intent of this Statement of Policy.

The information that lawyers may properly give to the auditor concerning the foregoing matters would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote"; for purposes of any such judgment it is appropriate to use the following meanings:

(i) *probable*—an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.

(ii) *remote*—an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is “probable” or “remote,” applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.

The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be “remote.” In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

The considerations bearing upon the difficulty in estimating loss (or range of loss) where pending litigation is concerned are obviously even more compelling in the case of unasserted possible claims. In most cases, the lawyer will not be able to provide any such estimate to the auditor.

As indicated in Paragraph 4 hereof, the auditor may assume that all loss contingencies specified by the client in the manner specified in clauses (b) and (c) above have received comment in the response, unless otherwise therein indicated. The lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by this Paragraph 5.

(6) *Lawyer's Professional Responsibility.* Independent of the scope of his response to the auditor's request for information, the lawyer, depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. In appropriate circumstances, the lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements\* of FAS 5.

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\* Under FAS 5, when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, disclosure of an unasserted possible claim is required only if the enterprise concludes that (i) it is probable that a claim will be asserted, (ii) there is a

(7) *Limitation on Use of Response.* Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent.<sup>†</sup> Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if the situation does not permit such period of notice.<sup>†</sup>

(8) *General.* This Statement of Policy, together with the accompanying Commentary (which is an integral part hereof), has been developed for the general guidance of the legal profession. In a particular case, the lawyer may elect to supplement or modify the approach hereby set forth. If desired, this Statement of Policy may be incorporated by reference in the lawyer's response by the following statement: "This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any 'loss contingencies' is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement)."

*The accompanying Commentary is an integral part of this Statement of Policy.*

## Commentary

### Paragraph 1 (Client Consent to Response)

In responding to any aspect of an auditor's inquiry letter, the lawyer must be guided by his ethical obligations as set forth in the Code of Professional Responsibility. Under Canon 4 of the Code of Professional Responsibility a lawyer is enjoined to preserve the client's confidences (defined as information protected by the attorney-client privilege under applicable law) and the client's secrets (defined as other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client). The observance of this ethical obligation, in the context of public policy, "... not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance." (Ethical Consideration 4-1).

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(Footnote Continued)

reasonable possibility, if the claim is in fact asserted, that the outcome will be unfavorable, and (iii) the liability resulting from such unfavorable outcome would be material to its financial condition.

<sup>†</sup> As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

The lawyer's ethical obligation therefore includes a much broader range of information than that protected by the attorney-client privilege. As stated in Ethical Consideration 4-4: "The attorney-client privilege is more limited than the ethical obligation of a lawyer to guard the confidences and secrets of his client. This ethical precept, unlike the evidentiary privilege, exists without regard to the nature or source of information or the fact that others share the knowledge."

In recognition of this ethical obligation, the lawyer should be careful to disclose fully to his client any confidence, secret or evaluation that is to be revealed to another, including the client's auditor, and to satisfy himself that the officer or agent of a corporate client consenting to the disclosure understands the legal consequences thereof and has authority to provide the required consent.

The law in the area of attorney-client privilege and the impact of statements made in letters to auditors upon that privilege has not yet been developed. Based upon cases treating the attorney-client privilege in other contexts, however, certain generalizations can be made with respect to the possible impact of statements in letters to auditors.

It is now generally accepted that a corporation may claim the attorney-client privilege. Whether the privilege extends beyond the control group of the corporation (a concept found in the existing decisional authority), and if so, how far, is yet unresolved.

If a client discloses to a third party a part of any privileged communication he has made to his attorney, there may have been a waiver as to the whole communication; further, it has been suggested that giving accountants access to privileged statements made to attorneys may waive any privilege as to those statements. Any disclosure of privileged communications relating to a particular subject matter may have the effect of waiving the privilege on other communications with respect to the same subject matter.

To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.

A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.

Another danger inherent in a lawyer's placing a value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.

## **Paragraph 2 (Limitation on Scope of Response)**

In furnishing information to an auditor, the lawyer can properly limit himself to loss contingencies which he is handling on a substantive basis for the client in the form of legal consultation (advice and other attention to matters not in litigation by the lawyer in his professional capacity) or legal

representation (counsel of record or other direct professional responsibility for a matter in litigation). Some auditors' inquiries go further and ask for information on matters of which the lawyer "has knowledge." Lawyers are concerned that such a broad request may be deemed to include information coming from a variety of sources including social contact and thirdparty contacts as well as professional engagement and that the lawyer might be criticized or subjected to liability if some of this information is forgotten at the time of the auditor's request.

It is also believed appropriate to recognize that the lawyer will not necessarily have been authorized to investigate, or have investigated, all legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem upon exploration and development. Thus, consideration in the form of preliminary or passing advice, or regarding an incomplete or hypothetical state of facts, or where the lawyer has not been requested to give studied attention to the matter in question, would not come within the concept of "substantive attention" and would therefore be excluded. Similarly excluded are matters which may have been mentioned by the client but which are not actually being handled by the lawyer. Paragraph 2 undertakes to deal with these concerns.

Paragraph 2 is also intended to recognize the principle that the appropriate lawyer to respond as to a particular loss contingency is the lawyer having charge of the matter for the client (e.g., the lawyer representing the client in a litigation matter and/or the lawyer having overall charge and supervision of the matter), and that the lawyer not having that kind of role with respect to the matter should not be expected to respond merely because of having become aware of its existence in a general or incidental way.

The internal procedures to be followed by a law firm or law department may vary based on factors such as the scope of the lawyer's engagement and the complexity and magnitude of the client's affairs. Such procedures could, but need not, include use of a docket system to record litigation, consultation with lawyers in the firm or department having principal responsibility for the client's affairs or other procedures which, in light of the cost to the client, are not disproportionate to the anticipated benefit to be derived. Although these procedures may not necessarily identify all matters relevant to the response, the evolution and application of the lawyer's customary procedures should constitute a reasonable basis for the lawyer's response.

As the lawyer's response is limited to matters involving his professional engagement as counsel, such response should not include information concerning the client which the lawyer receives in another role. In particular, a lawyer who is also a director or officer of the client would not include information which he received as a director or officer unless the information was also received (or, absent the dual role, would in the normal course be received) in his capacity as legal counsel in the context of his professional engagement. Where the auditor's request for information is addressed to a law firm as a firm, the law firm may properly assume that its response is not expected to include any information which may have been communicated to the particular individual by reason of his serving in the capacity of director or officer of the client. The question of the individual's duty, in his role as a director or officer, is not here addressed.

### **Paragraph 3 (Response May Cover only Material Items in Certain Cases)**

Paragraph 3 makes it clear that the lawyer may optionally limit his responses to those items which are individually or collectively material to the

auditor's inquiry. If the lawyer takes responsibility for making a determination that a matter is not material for the purposes of his response to the audit inquiry, he should make it clear that his response is so limited. The auditor, in such circumstance, should properly be entitled to rely upon the lawyer's response as providing him with the necessary corroboration. It should be emphasized that the employment of inside general counsel by the client should not detract from the acceptability of his response since inside general counsel is as fully bound by the professional obligations and responsibilities contained in the Code of Professional Responsibility as outside counsel. If the audit inquiry sets forth a definition of materiality but the lawyer utilizes a different test of materiality, he should specifically so state. The lawyer may wish to reach an understanding with the auditor concerning the test of materiality to be used in his response, but he need not do so if he assumes responsibility for the criteria used in making materiality determinations. Any such understanding with the auditor should be referred to or set forth in the lawyer's response. In this connection, it is assumed that the test of materiality so agreed upon would not be so low in amount as to result in a disservice to the client and an unreasonable burden on counsel.

#### **Paragraph 4 (Limited Responses)**

The Statement of Policy is designed to recognize the obligation of the auditor to complete the procedures considered necessary to satisfy himself as to the fair presentation of the company's financial condition and results, in order to render a report which includes an opinion not qualified because of a limitation on the scope of the audit. In this connection, reference is made to SEC Accounting Series Release No. 90 [Financial Reporting Release No. 1, section 607.01(b)], in which it is stated:

"A 'subject to' or 'except for' opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The 'subject to' qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date."

[The next page is 407.]

## Paragraph 5 (Loss Contingencies)

Paragraph 5 of the Statement of Policy summarizes the categories of "loss contingencies" about which the lawyer may furnish information to the auditor. The term loss contingencies and the categories relate to concepts of accounting accrual and disclosure specified for the accounting profession in Statement of Financial Accounting Standards No. 5 ("FAS 5") issued by the Financial Accounting Standards Board in March, 1975.

### 5.1 Accounting Requirements

To understand the significance of the auditor's inquiry and the implications of any response the lawyer may give, the lawyer should be aware of the following accounting concepts and requirements set out in FAS 5:\*

(a) A "loss contingency" is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.

(Para. 1)

(b) When a "loss contingency" exists, the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. There are three areas within that range, defined as follows:

(i) *Probable*—"The future event or events are likely to occur."

(ii) *Reasonably possible*—"The chance of the future event or events occurring is more than remote but less than likely."

(iii) *Remote*—"The chance of the future event or events occurring is slight."

(Para. 3)

(c) *Accrual* in a client's financial statements by a charge to income of the period will be required if *both* the following conditions are met:

(i) "Information available prior to issuance of the financial statements indicates that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be *probable* that one or more future events will occur confirming the fact of the loss." (emphasis added; footnote omitted)

(ii) "The amount of loss can be reasonably estimated."

(Para. 8)

(d) If there is no *accrual* of the loss contingency in the client's financial statements because one of the two conditions outlined in (c)

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\* Citations are to paragraph numbers of FAS 5.



above are not met, *disclosure* may be required as provided in the following:

*“If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.”* (emphasis added; footnote omitted)

(Para. 10)

(e) The accounting requirements recognize or specify that (i) the opinions or views of counsel are not the sole source of evidential matter in making determinations about the accounting recognition or treatment to be given to litigation, and (ii) the fact that the lawyer is not able to express an opinion that the outcome will be favorable does not necessarily require an accrual of a loss. Paragraphs 36 and 37 of FAS 5 state as follows:

“If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise’s financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise’s management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

“The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would

be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement.”

(f) Paragraph 38 of FAS 5 focuses on certain examples concerning the determination by the enterprise whether an assertion of an *unasserted possible claim* may be considered probable:

“With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise’s patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10.”

For a more complete presentation of FAS 5, reference is made to Exhibit I, section 337B, in which are set forth excerpts selected by the AICPA as relevant to a Statement on Auditing Standards, issued by its Auditing Standards Executive Committee, captioned “Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments.”

### 5.2 Lawyer’s Response

Concepts of probability inherent in the usage of terms like “probable” or “reasonably possible” or “remote” mean different things in different contexts. Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of “probability” that may be applicable when

determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises. While lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation and may change dramatically depending upon the development of the proceedings. Lawyers do not generally quantify for clients the “odds” in numerical terms; if they do, the quantification is generally only undertaken in an effort to make meaningful, for limited purposes, a whole host of judgmental factors applicable at a particular time, without any intention to depict “probability” in any statistical, scientific or empirically-grounded sense. Thus, for example, statements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.

Likewise, the “amount” of loss—that is, the total of costs and damages that ultimately might be assessed against a client—will, in most litigation, be a subject of wide possible variance at most stages; it is the rare case where the amount is precise and where the question is whether the client against which claim is made is liable either for all of it or none of it.

In light of the foregoing considerations, it must be concluded that, as a general rule, it should not be anticipated that meaningful quantifications of “probability” of outcome or amount of damages can be given by lawyers in assessing litigation. To provide content to the definitions set forth in Paragraph 5 of the Statement of Policy, this Commentary amplifies the meanings of the terms under discussion, as follows:

*“probable”*—An unfavorable outcome is normally “probable” if, but only if, investigation, preparation (including development of the factual data and legal research) and progress of the matter have reached a stage where a judgment can be made, taking all relevant factors into account which may affect the outcome, that it is extremely doubtful that the client will prevail.

*“remote”*—The prospect for an unfavorable outcome appears, at the time, to be slight; i.e., it is extremely doubtful that the client will not prevail. Normally, this would entail the ability to make an unqualified judgment, taking into account all relevant factors which may affect the outcome, that the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law.

In other words, for purposes of the lawyer’s response to the request to advise auditors about litigation, an unfavorable outcome will be “probable” only if the chances of the client prevailing appear slight and of the claimant losing appear extremely doubtful; it will be “remote” when the client’s chances of losing appear slight and of not winning appear extremely doubtful. It is, therefore, to be anticipated that, in most situations, an unfavorable

outcome will be neither "probable" nor "remote" as defined in the Statement of Policy.

The discussion above about the very limited basis for furnishing judgments about the outcome of litigation applies with even more force to a judgment concerning whether or not the assertion of a claim not yet asserted is "probable." That judgment will infrequently be one within the professional competence of lawyers and therefore the lawyer should not undertake such assessment except where such judgment may become meaningful because of the presence of special circumstances, such as catastrophes, investigations and previous public disclosure as cited in Paragraph 5 of the Statement of Policy, or similar extrinsic evidence relevant to such assessment. Moreover, it is unlikely, absent relevant extrinsic evidence, that the client or anyone else will be in a position to make an informed judgment that assertion of a possible claim is "probable" as opposed to "reasonably possible" (in which event disclosure is not required). In light of the legitimate concern that the public interest would not be well served by resolving uncertainties in a way that invites the assertion of claims or otherwise causes unnecessary harm to the client and its stockholders, a decision to treat an unasserted claim as "probable" of assertion should be based only upon compelling judgment.

Consistent with these limitations believed appropriate for the lawyer, he should not represent to the auditor, nor should any inference from his response be drawn, that the unasserted possible claims identified by the client (as contemplated by Paragraph 5(c) of the Statement of Policy) represent all such claims of which the lawyer may be aware or that he necessarily concurs in his client's determination of which unasserted possible claims warrant specification by the client; within proper limits, this determination is one which the client is entitled to make—and should make—and it would be inconsistent with his professional obligations for the lawyer to volunteer information arising from his confidential relationship with his client.

As indicated in Paragraph 5, the lawyer also may be asked to estimate the potential loss (or range) in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the lawyer would provide an estimate only if he believes that the probability of inaccuracy of the estimate of the range or amount is slight. What is meant here is that the estimate of amount of loss presents the same difficulty as assessment of outcome and that the same formulation of "probability" should be used with respect to the determination of estimated loss amounts as should be used with respect to estimating the outcome of the matter.

In special circumstances, with the proper consent of the client, the lawyer may be better able to provide the auditor with information concerning loss contingencies through conferences where there is opportunity for more detailed discussion and interchange. However, the principles set forth in the Statement of Policy and this Commentary are fully applicable to such conferences.

Subsumed throughout this discussion is the ongoing responsibility of the lawyer to assist his client, at the client's request, in complying with the

requirements of FAS 5 to the extent such assistance falls within his professional competence. This will continue to involve, to the extent appropriate, privileged discussions with the client to provide a better basis on which the client can make accrual and disclosure determinations in respect of its financial statements.

In addition to the considerations discussed above with respect to the making of any judgment or estimate by the lawyer in his response to the auditor, including with respect to a matter specifically identified by the client, the lawyer should also bear in mind the risk that the furnishing of such a judgment or estimate to any one other than the client might constitute an admission or be otherwise prejudicial to the client's position in its defense against such litigation or claim (see Paragraph 1 of the Statement of Policy and of this Commentary).

### **Paragraph 6 (Lawyer's Professional Responsibility)**

The client must satisfy whatever duties it has relative to timely disclosure, including appropriate disclosure concerning material loss contingencies, and, to the extent such matters are given substantive attention in the form of legal consultation, the lawyer, when his engagement is to advise his client concerning a disclosure obligation, has a responsibility to advise his client concerning its obligations in this regard. Although lawyers who normally confine themselves to a legal specialty such as tax, antitrust, patent or admiralty law, unlike lawyers consulted about SEC or general corporate matters, would not be expected to advise generally concerning the client's disclosure obligations in respect of a matter on which the lawyer is working, the legal specialist should counsel his client with respect to the client's obligations under FAS 5 to the extent contemplated herein. Without regard to legal specialty, the lawyer should be mindful of his professional responsibility to the client described in Paragraph 6 of the Statement of Policy concerning disclosure.

The lawyer's responsibilities with respect to his client's disclosure obligations have been a subject of considerable discussion and there may be, in due course, clarification and further guidance in this regard. In any event, where in the lawyer's view it is clear that (i) the matter is of material importance and seriousness, and (ii) there can be no reasonable doubt that its non-disclosure in the client's financial statements would be a violation of law giving rise to material claims, rejection by the client of his advice to call the matter to the attention of the auditor would almost certainly require the lawyer's withdrawal from employment in accordance with the Code of Professional Responsibility. (See, e.g., Disciplinary Rule 7-102 (A)(3) and (7), and Disciplinary Rule 2-110 (B)(2).) Withdrawal under such circumstances is obviously undesirable and might present serious problems for the client. Accordingly, in the context of financial accounting and reporting for loss contingencies arising from unasserted claims, the standards for which are contained in FAS 5, clients should be urged to disclose to the auditor information concerning an unasserted possible claim or assessment (not

otherwise specifically identified by the client) where in the course of the services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable (employing the concepts hereby enunciated) and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required.

### **Paragraph 7 (Limitation on Use of Response)**

Some inquiry letters make specific reference to, and one might infer from others, an intention to quote verbatim or include the substance of the lawyer's reply in footnotes to the client's financial statements. Because the client's prospects in pending litigation may shift as a result of interim developments, and because the lawyer should have an opportunity, if quotation is to be made, to review the footnote in full, it would seem prudent to limit the use of the lawyer's reply letter. Paragraph 7 sets out such a limitation.

Paragraph 7 also recognizes that it may be in the client's interest to protect information contained in the lawyer's response to the auditor, if and to the extent possible, against unnecessary further disclosure or use beyond its intended purpose of informing the auditor. For example, the response may contain information which could prejudice efforts to negotiate a favorable settlement of a pending litigation described in the response. The requirement of consent to further disclosure, or of reasonable advance notice where disclosure may be required by court process or necessary in defense of the audit, is designed to give the lawyer an opportunity to consult with the client as to whether consent should be refused or limited or, in the case of legal process or the auditor's defense of the audit, as to whether steps can and should be taken to challenge the necessity of further disclosure or to seek protective measures in connection therewith. It is believed that the suggested standard of twenty days advance notice would normally be a minimum reasonable time for this purpose.

### **Paragraph 8 (General)**

It is reasonable to assume that the Statement of Policy will receive wide distribution and will be readily available to the accounting profession. Specifically, the Statement of Policy has been reprinted as Exhibit II to the Statement on Auditing Standards, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," issued by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants. Accordingly, the mechanic for its incorporation by reference will facilitate lawyer-auditor communication. The incorporation is intended to include not only limitations, such as those provided by Paragraphs 2 and 7 of the Statement of Policy, but also the explanatory material set forth in this Commentary.

## Annex A

[Illustrative forms of letters for full response by outside practitioner or law firm and inside general counsel to the auditor's inquiry letter. These illustrative forms, which are not part of the Statement of Policy, have been prepared by the Committee on Audit Inquiry Responses solely in order to assist those who may wish to have, for reference purposes, a form of response which incorporates the principles of the Statement of Policy and accompanying Commentary. Other forms of response letters will be appropriate depending on the circumstances.]

*Illustrative form of letter for use by outside practitioner or law firm:*

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

By letter dated [insert date of request] Mr. [insert name and title of officer signing request] of [insert name of client] [(the "Company") or (together with its subsidiaries, the "Company"))] has requested us to furnish you with certain information in connection with your examination of the accounts of the Company as at [insert fiscal year-end].

[Insert description of the scope of the lawyer's engagement; the following are sample descriptions:]

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm has during the past year represented the Company only in connection with certain [Federal income tax matters] [litigation] [real estate transactions] [describe other specific matters, as appropriate] and has not been engaged for any other purpose.

Subject to the foregoing and to the last paragraph of this letter, we advise you that since [insert date of beginning of fiscal period under audit] we have not been engaged to give substantive attention to, or represent the Company in connection with, [material]\* loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If the inquiry letter requests information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations:]

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\* NOTE: See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

With respect to the matters specifically identified in the Company's letter and upon which comment has been specifically requested, as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, we advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of *[insert date]*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and we disclaim any undertaking to advise you of changes which thereafter may be brought to our attention.

[Insert information with respect to outstanding bills for services and disbursements.]

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement]

Very truly yours,



*Illustrative form of letter for use by inside general counsel:*

[Name and Address of Accounting Firm]

Re: [Name of Company] [and Subsidiaries]

Dear Sirs:

As General Counsel\* of [insert name of client] [(the "Company")], [together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [insert fiscal year-end].

I call your attention to the fact that as General Counsel\* for the Company I have general supervision of the Company's legal affairs. [If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance should be placed on other sources.] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise you that since [insert date of beginning of fiscal period under audit] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material]\*\* loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]

With respect to matters which have been specifically identified as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [[as of the date of this letter] as of [insert date], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and I disclaim any undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.

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\* It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

\*\* NOTE: See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

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[The next page is 421.]

**AU Section 9337*****Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337*****1. Specifying Relevant Date in an Audit Inquiry Letter**

**.01 Question**—Should the auditor request the client to specify, in his audit inquiry letter to a lawyer prepared in accordance with section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, the date by which the lawyer's response should be sent to the auditor. Also, should the letter request the lawyer to specify in his response the latest date covered by his review (the "effective date")?

**.02 Interpretation**—Yes. It should be recognized that, to adequately respond to an audit inquiry letter, lawyers will ordinarily employ some internal review procedures which will be facilitated by specifying the earliest acceptable effective date of the response and the latest date by which it should be sent to the auditor. Ordinarily, a two-week period should be allowed between the specified effective date of the lawyer's response and the latest date by which the response should be sent to the auditor. Clearly stating the relevant dates in the letter and specifying these dates to the lawyer in a timely manner will allow the responding lawyer an adequate amount of time to complete his review procedures and assist the auditor in coordinating the timing of the completion of his field work with the latest date covered by the lawyer's review.

**.03** Further, the lawyer should be requested to specify the effective date of his response. If the lawyer's response does not specify an effective date, the auditor can assume that the date of the lawyer's response is the effective date.

[Issue Date: March, 1977.]

**2. Relationship Between Date of Lawyer's Response and Auditor's Report**

**.04 Question**—The illustrative form of audit inquiry letter included in the Appendix to section 337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," requests a response as to matters that existed at the balance sheet date and during the period from that date to the date of the response. What is the relationship between the effective date of the lawyer's response and the date of the auditor's report, which is generally the date of the completion of field work?

**.05 Interpretation**—Section 560.10-12 indicates that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the completion of field work as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the completion of the

field work will in most instances obviate the need for an updated response from the lawyer.

[Issue Date: March, 1977.]

### **3. Form of Audit Inquiry Letter when Client Represents that No Unasserted Claims and Assessments Exist**

**.06 Question**—The illustrative audit inquiry letter included in the Appendix to section 337, “Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments,” assumes that the client specifies certain unasserted claims and assessments. However, in some cases, clients have stated that there are no such claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome. What appropriate revision to the wording of the letter can be used in such situations?

**.07 Interpretation**—Wording that could be used in an audit inquiry letter, instead of the heading and first paragraph in the section relating to unasserted claims and assessments included in the Appendix to section 337, when the client believes that there are no unasserted claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by FASB Statement of Financial Accounting Standards No. 5 [AC section C59], “Accounting for Contingencies,” is as follows:

*Unasserted claims and assessments*—We have represented to our auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed, in accordance with Statement of Financial Accounting Standards No. 5. (The second paragraph in the section relating to unasserted claims and assessments would not be altered.)

[Issue Date: March, 1977.]

### **4. Documents Subject to Lawyer-Client Privilege**

**.08 Question**—Section 337, *Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments*, paragraph .05c, states: “Examine documents in the client’s possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.” Would this include a review of documents at the client’s location considered by the lawyer and the client to be subject to the lawyer-client privilege?

**.09 Interpretation**—No. Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his audit as a scope restriction, in recognition of the public interest in protecting the confidentiality of lawyer-client communications (see section 337.13), section 337.05c is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege. In the event of questions concerning the applicability of this privilege, the auditor may request confirmation from the client’s counsel that the information is subject to that privilege and that the information was considered by the lawyer in responding to the audit inquiry letter or, if the matters are being handled by another lawyer, an identification of such lawyer for the purpose of sending him an audit inquiry letter.

[Issue Date: March, 1977.]

## 5. Alternative Wording of the Illustrative Audit Inquiry Letter to a Client's Lawyer

**.10 Question**—The appendix of section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, provides an illustrative audit inquiry letter to legal counsel. That inquiry letter is based on the assumptions that (1) management of the company has prepared and furnished to the auditor and has set forth in the audit inquiry letter a description and evaluation of pending or threatened litigation, claims, and assessments and (2) management has identified and specified for comment in the audit inquiry letter unasserted claims or assessments that are probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome. In many engagements, circumstances may render certain portions of the illustrative letter inappropriate. For instance, many clients ask their lawyers to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments rather than have management furnish such information. How can the wording of the inquiry letter be modified to recognize circumstances that differ from those assumed in the illustrative letter and to be more specific regarding the timing of the lawyer's response?

**.11 Interpretation**—Section 337.09, outlines the matters that should be covered in a letter of audit inquiry. Although section 337 provides an illustrative audit inquiry letter to legal counsel, it should be modified, if necessary, to fit the circumstances. The modified illustrative audit inquiry letter that follows is based on a typical situation: management requests the lawyer to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments, and also represents that there are no unasserted claims or assessments that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by FASB Statement No. 5, *Accounting for Contingencies* [AC section C59]. It also includes a separate response section with language that clarifies the auditor's expectations regarding the timing of the lawyer's response.

"In connection with an audit of our financial statements as of (balance-sheet date) and for the (period) then ended, please furnish our auditors, (name and address of auditors), with the information requested below concerning certain contingencies involving matters with respect to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation." [When a materiality limit has been established based on an understanding between management and the auditor, the following sentence should be added: This request is limited to contingencies amounting to (amount) individually or items involving lesser amounts that exceed (amount) in the aggregate.]

### **.12 Pending or Threatened Litigation, Claims, and Assessments**

"Regarding pending or threatened litigation, claims, and assessments, please include in your response: (1) the nature of each matter, (2) the progress of each matter to date, (3) how the Company is responding or intends to respond (for example, to contest the case vigorously or seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss."

### **.13 Unasserted Claims and Assessments**

"We have represented to our auditors that there are no unasserted possible claims or assessments that you have advised us are probable of

assertion and must be disclosed in accordance with FASB Statement No. 5 [AC section C59].<sup>1</sup> We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of FASB Statement No. 5 [AC section C59]. Please specifically confirm to our auditors that our understanding is correct.”

#### **.14 Response**

“Your response should include matters that existed as of (balance-sheet date) and during the period from that date to the effective date of your response.”

“Please specifically identify the nature of and reasons for any limitations on your response.”

“Our auditors expect to have the audit completed about (expected completion date). They would appreciate receiving your reply by that date with a specified effective date no earlier than (ordinarily two weeks before expected completion date).”<sup>2</sup>

[Issue Date: June 1983.]

## **6. Client Has Not Consulted a Lawyer**

**.15 Question**—Section 337.06 requires an auditor to request that the client’s management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, or assessments. In some instances, management may not have consulted a lawyer. In such circumstances, what should the auditor do to obtain sufficient, competent evidential matter regarding litigation, claims, and assessments?

**.16 Interpretation**—Section 337 is expressly limited to inquiry of lawyers with whom management has consulted. If the client has not consulted a lawyer, the auditor normally would rely on the review of internally available information as outlined in section 337.05 and .07, and the written representation of management regarding litigation, claims, and assessments as required by section 333, *Client Representations*, paragraph 4r and s. In those circumstances, the representation regarding litigation, claims, and assessments might be worded as follows:

“We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59], and we have not consulted a lawyer concerning litigation, claims, or assessments.”

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<sup>1</sup> A parenthetical statement such as “(excerpts of which can be found in the ABA’s *Auditor’s Letter Handbook*)” might be added here if the auditor believes that it would be helpful to the lawyer’s understanding of the requirements of FASB Statement No. 5 [AC section C59]. The *Auditor’s Letter Handbook* contains, among other things, a copy of section 337 the ABA’s *Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information*, and excerpts from FASB Statement No. 5 [AC section C59].

<sup>2</sup> Two auditing interpretations (see sections 9337.01—.05) address relevant dates in an audit inquiry letter and the relationship between the date of the lawyer’s response and the audit report date. See JofA, Mar. 77, pp. 101—102.

.17 If information comes to the auditor's attention that may indicate potentially material litigation, claims, and assessments, the auditor should discuss with the client its possible need to consult legal counsel so that the client may evaluate its responsibility under FASB Statement No. 5 [AC section C59] to accrue or disclose loss contingencies. Depending on the severity of the matter, refusal by the client to consult legal counsel in those circumstances may result in a scope limitation, and the auditor should consider the effect of such a limitation on his audit report.

[Issue Date: June 1983.]

## 7. Assessment of a Lawyer's Evaluation of the Outcome of Litigation

.18 *Question*—Section 337.09d(2), *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, states that a letter of audit inquiry should include a request for the lawyer's evaluation of the likelihood of an unfavorable outcome of pending or threatened litigation, claims, and assessments to which he has devoted substantive attention. However, written responses from lawyers vary considerably and may contain evaluation wording that is vague or ambiguous and, thus, of limited use to the auditor. What constitutes a clear response and what should the auditor do if he considers the response unclear?

.19 *Interpretation*—The American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (ABA Statement) is reprinted as Exhibit II to section 337. While paragraph 5 of the ABA Statement states that the lawyer "may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is 'probable' or 'remote,'" he is not required to use those terms in communicating his evaluation to the auditor. The auditor may find other wording sufficiently clear as long as the terms can be used to classify the outcome of the uncertainty under one of the three probability classifications established in FASB Statement No. 5 [AC section C59], *Accounting for Contingencies*.<sup>3</sup>

.20 Some examples of evaluations concerning litigation that may be considered to provide sufficient clarity that the likelihood of an unfavorable outcome is "remote" even though they do not use that term are:

- ☐ "We are of the opinion that this action will not result in any liability to the company."
- ☐ "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."
- ☐ "We believe the company will be able to defend this action successfully."
- ☐ "We believe that the plaintiff's case against the company is without merit."
- ☐ "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits."

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<sup>3</sup> FASB Statement No. 5 [AC section C59] uses the terms "probable," "reasonably possible," and "remote" to describe different degrees of likelihood that future events will confirm a loss or an impairment of an asset or incurrence of a liability, and the accounting standards for accrual and disclosure are based on those terms. (See section 508.23—.26)

.21 Absent any contradictory information obtained by the auditor either in other parts of the lawyer's letter or otherwise, the auditor need not obtain further clarification of evaluations such as the foregoing.

.22 Because of inherent uncertainties described in section 337.14 and in the ABA Policy Statement, an evaluation furnished by the lawyer may indicate significant uncertainties or stipulations as to whether the client will prevail. The following are examples of lawyers' evaluations that are unclear as to the likelihood of an unfavorable outcome:

- ☐ "This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."
- ☐ "It is our opinion that the company will be able to assert meritorious defenses to this action." (The term "meritorious defenses" indicates that the company's defenses will not be summarily dismissed by the court; it does not necessarily indicate counsel's opinion that the company will prevail.)
- ☐ "We believe the action can be settled for less than the damages claimed."
- ☐ "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation." (If client's counsel, with the benefit of all relevant information, is unable to conclude that the likelihood of an unfavorable outcome is "remote," it is unlikely that management would be able to form a judgment to that effect.)
- ☐ "In our opinion, the company has a substantial chance of prevailing in this action." (A "substantial chance," a "reasonable opportunity," and similar terms indicate more uncertainty than an opinion that the company will prevail.)

.23 If the auditor is uncertain as to the meaning of the lawyer's evaluation, he should request clarification either in a follow-up letter or a conference with the lawyer and client, appropriately documented. If the lawyer is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor should consider adding an explanatory paragraph because of the uncertainty (see section 508.16—.33).

[Issue Date: June 1983.]

## **8. Use of the Client's Inside Counsel in the Evaluation of Litigation, Claims, and Assessments**

.24 *Question*—Section 337.06 requires an auditor to request that the client's management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, and assessments. Sometimes, the client's inside general counsel or legal department (hereinafter referred to as "inside counsel") is handling litigation, claims, and assessments either exclusive of or in conjunction with outside lawyers. In such circumstances, when does inside counsel's response constitute sufficient, competent evidential matter regarding litigation, claims, and assessments?



**.25 Interpretation**—Section 337.08 states that “Evidential matter obtained from the client’s inside general counsel or legal department may provide the auditor with the necessary corroboration.” Inside counsel can range from one lawyer to a large staff, with responsibilities ranging from specific internal matters to a comprehensive coverage of all of the client’s legal needs, including litigation with outside parties. Because both inside counsel and outside lawyers are bound by the ABA’s Code of Professional Responsibilities, there is no difference in their professional obligations and responsibilities. In some circumstances, outside lawyers, if used at all, may be used only for limited purposes, such as data accumulation or account collection activity. In such circumstances, inside counsel has the primary responsibility for corporate legal matters and is in the best position to know and precisely describe the status of all litigation, claims, and assessments or to corroborate information furnished by management.

**.26** Audit inquiry letters should be sent to those lawyers, which may be either inside counsel or outside lawyers, who have the primary responsibility for, and knowledge about, particular litigation, claims, and assessments. If inside counsel in handling litigation, claims, and assessments exclusively, their evaluation and response ordinarily would be considered adequate. Similarly, if both inside counsel and outside lawyers have been involved in the matters, but inside counsel has assumed the primary responsibility for the matters, inside counsel’s evaluation may well be considered adequate.<sup>4</sup> However, there may be circumstances when litigation, claims, or assessments involving substantial overall participation by outside lawyers are of such significance to the financial statements that the auditor should consider obtaining the outside lawyers’ response that they have not formulated a substantive conclusion that differs in any material respect from inside counsel’s evaluation, even though inside counsel may have primary responsibility.

**.27** If both inside counsel and outside lawyers have devoted substantive attention to a legal matter, but their evaluations of the possible outcome differ, the auditor should discuss the differences with the parties involved. Failure to reach agreement between the lawyers may require the auditor to consider appropriate modification of his audit report.

[Issue Date: June 1983.]

## **9. Use of Explanatory Language About the Attorney-Client Privilege or the Attorney Work-Product Privilege**

**.28 Question**—In some cases, in order to emphasize the preservation of the attorney-client privilege or the attorney work-product privilege, some clients have included the following or substantially similar language in the audit inquiry letter to legal counsel:

We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

For the same reason, some lawyers have included the following or substantially similar language in their response letters to auditors:

The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company

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<sup>4</sup> This does not alter the caveat in section 337.08 that “evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish.”

[OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

Does the explanatory language about the attorney-client privilege or the attorney work-product privilege result in a limitation on the scope of the audit?

**.29 Answer**—No. According to the *Report by the American Bar Association's Subcommittee on Audit Inquiry Responses*, explanatory language similar to the foregoing in the letters of the client or the lawyer is not a limitation on the scope of the lawyer's response. The report states that such language simply makes explicit what has always been implicit, namely, the language states clearly that neither the client nor the lawyer intended a waiver. The report further states that non-inclusion of either or both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges. The *Report by the American Bar Association's Subcommittee on Audit Inquiry Responses* is reprinted in paragraph .30.

### **.30 Report of the Subcommittee on Audit Inquiry Responses\***

Because of a recent court case and other judicial decisions involving lawyers' responses to auditors' requests for information, an area of uncertainty or concern has been brought to the Subcommittee's attention and is the subject of the following comment:

This Committee's report does not modify the ABA Statement of Policy, nor does it constitute an interpretation thereof. The Preamble to the ABA Statement of Policy states as follows:

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become

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\* "Excerpted from 'Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information,' *The Business Lawyer*, vol. 31, no. 3, April 1976, copyright 1976 American Bar Association, reprinted by permission of the American Bar Association."

public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political, and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Paragraph (1) of the ABA Statement of Policy provides as follows:

(1) *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying Commentary), to the extent hereinafter set forth, subject to the following:

(a) Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.

(b) In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.

(c) Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.

(d) In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

In order to preserve explicitly the evidentiary privileges, some lawyers have suggested that clients include language in the following or substantially similar form:

We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

If client's request letter does not contain language similar to that in the preceding paragraph, the lawyer's statement that the client has so advised

him or her may be based upon the fact that the client has in fact so advised the lawyer, in writing or orally, in other communications or in discussions.

For the same reason, the response letter from some lawyers also includes language in the following or substantially similar form:

The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company [OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

We believe that language similar to the foregoing in the letters of the client or the lawyer simply makes explicit what has always been implicit, namely, it expressly states clearly that neither the client nor the lawyer intended a waiver. It follows that non-inclusion of either nor both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges.

On the other hand, the inclusion of such language does not necessarily assure the client that, depending on the facts and circumstances, a waiver may not be found by a court of law to have occurred.

We do not believe that the foregoing types of inclusions cause a negative impact upon the public policy considerations described in the Preamble to the ABA Statement of Policy nor do they intrude upon the arrangements between the legal profession and the accounting profession contemplated by the ABA Statement of Policy. Moreover, we do not believe that such language interferes in any way with the standards and procedures of the accounting profession in the auditing process nor should it be construed as a limitation upon the lawyer's reply to the auditors. We have been informed that the Auditing Standards Board of the AICPA has adopted an interpretation to SAS 12 recognizing the propriety of these statements.

Lawyers, in any case, should be encouraged to have their draft letters to auditors reviewed and approved by the client before releasing them to the auditors and may wish to explain to the client the legal consequences of the client's consent to the lawyer's response as contemplated by sub-paragraph 1(d) of the Statement of Policy.

December 1989

[Issue Date: February, 1990.]

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[The next page is 435.]

## AU Section 339

### Working Papers

(Supersedes Statement on Auditing Standards No. 1, section 338, "Working Papers.")<sup>1</sup>

Source: SAS No. 41.

Issue date, unless otherwise indicated: April 1, 1982.

.01 The auditor should prepare and maintain working papers, the form and content of which should be designed to meet the circumstances of a particular engagement.<sup>2</sup> The information contained in working papers constitutes the principal record of the work that the auditor has done and the conclusions that he has reached concerning significant matters.<sup>3</sup>

### Functions and Nature of Working Papers

.02 Working papers serve mainly to—

- a. Provide the principal support for the auditor's report, including his representation regarding observance of the standards of field work, which is implicit in the reference in his report to generally accepted auditing standards.
- b. Aid the auditor in the conduct and supervision of the audit.

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<sup>1</sup> This section amends section 230, *Due Care in the Performance of Work*, paragraph .04, by deleting the second sentence of that paragraph.

<sup>2</sup> This section does not modify the guidance in other Statements on Auditing Standards, including the following:

- The letter of audit inquiry to the client's lawyer required by section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, paragraphs .08—.09, or the documentation required by paragraph .10 when a response to the audit inquiry letter is received in a conference
- The written representations from management required by section 333, *Client Representations*
- The notation in the working papers required by section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit*, paragraph .09, if conditions relating to the internal control structure observed during an audit of financial statements are communicated orally to the audit committee or others with equivalent authority and responsibility
- The written audit program or set of written audit programs required by section 311, *Planning and Supervision*, paragraph .05
- The representation letter from a successor auditor required by section 711, *Filings Under Federal Securities Statutes*, paragraph .11b, when an auditor has audited the financial statements for prior periods but has not audited the financial statements for the most recent audited period included in a registration statement
- The understanding of the internal control structure elements obtained to plan the audit, and the basis for conclusions about the assessed level of control risk required by section 319.26 and 319.39, *Consideration of the Internal Control Structure in a Financial Statement Audit*.
- The notation in the working papers required by section 317, *Illegal Acts by Clients*, if illegal acts are communicated orally to the audit committee or others with equivalent authority and responsibility.
- The notation in the working papers required by section 380, *Communication With Audit Committees* (if applicable), paragraph .03, if matters regarding the scope and results of the audit are communicated orally to the committee.

<sup>3</sup> However, there is no intention to imply that the auditor would be precluded from supporting his report by other means in addition to working papers.

.03 Working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement. Examples of working papers are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor. Working papers also may be in the form of data stored on tapes, films, or other media.

.04 Factors affecting the auditor's judgment about the quantity, type, and content of the working papers for a particular engagement include (a) the nature of the engagement, (b) the nature of the auditor's report, (c) the nature of the financial statements, schedules, or other information on which the auditor is reporting, (d) the nature and condition of the client's records, (e) the assessed level of control risk, and (f) the needs in the particular circumstances for supervision and review of the work.

## Content of Working Papers

.05 The quantity, type, and content of working papers vary with the circumstances (see paragraph .04), but they should be sufficient to show that the accounting records agree or reconcile with the financial statements or other information reported on and that the applicable standards of field work have been observed. Working papers ordinarily should include documentation showing that—

- a. The work has been adequately planned and supervised, indicating observance of the first standard of field work.
- b. A sufficient understanding of the internal control structure has been obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
- c. The audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to afford a reasonable basis for an opinion, indicating observance of the third standard of field work.

## Ownership and Custody of Working Papers

.06 Working papers are the property of the auditor, and some states have statutes that designate the auditor as the owner of the working papers. The auditor's rights of ownership, however, are subject to ethical limitations relating to the confidential relationship with clients.

.07 Certain of the auditor's working papers may sometimes serve as a useful reference source for his client, but the working papers should not be regarded as a part of, or a substitute for, the client's accounting records.

.08 The auditor should adopt reasonable procedures for safe custody of his working papers and should retain them for a period sufficient to meet the needs of his practice and to satisfy any pertinent legal requirements of records retention.

## Effective Date

.09 This section is effective for engagements beginning after May 31, 1982.

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[The next page is 451.]

**AU Section 341*****The Auditor's Consideration of  
an Entity's Ability to Continue  
as a Going Concern***

(Supersedes section 340)

Source: SAS No. 59; SAS No. 64.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance to the auditor in conducting an audit of financial statements in accordance with generally accepted auditing standards with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.<sup>1, 2</sup> Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

**The Auditor's Responsibility**

.02 The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to as a *reasonable period of time*). The auditor's evaluation is based on his knowledge of relevant conditions and events that exist at or have occurred prior to the completion of fieldwork. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in section 326, *Evidential Matter*.

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<sup>1</sup> This section does not apply to an audit of financial statements based on the assumption of liquidation (for example, when [a] an entity is in the process of liquidation, [b] the owners have decided to commence dissolution or liquidation, or [c] legal proceedings, including bankruptcy, have reached a point at which dissolution or liquidation is probable). See Auditing Interpretation, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (section 9508.33—38).

<sup>2</sup> The guidance provided in this section applies to audits of financial statements prepared either in accordance with generally accepted accounting principles or in accordance with a comprehensive basis of accounting other than generally accepted accounting principles. References in this section to generally accepted accounting principles are intended to include a comprehensive basis of accounting other than generally accepted accounting principles (excluding liquidation basis).

**.03** The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

- a. The auditor considers whether the results of his procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. It may be necessary to obtain additional information about such conditions and events, as well as the appropriate evidential matter to support information that mitigates the auditor's doubt.
- b. If the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, he should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented.
- c. After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the opinion paragraph) in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

**.04** The auditor is not responsible for predicting future conditions or events. The fact that the entity may cease to exist as a going concern subsequent to receiving a report from the auditor that does not refer to substantial doubt, even within one year following the date of the financial statements, does not, in itself, indicate inadequate performance by the auditor. Accordingly, the absence of reference to substantial doubt in an auditor's report should not be viewed as providing assurance as to an entity's ability to continue as a going concern.

## Audit Procedures

**.05** It is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. The following are examples of procedures that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of stockholders, board of directors, and important committees of the board



- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support

## Consideration of Conditions and Events

.06 In performing audit procedures such as those presented in paragraph .05, the auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events:

- *Negative trends*—for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios
- *Other indications of possible financial difficulties*—for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets
- *Internal matters*—for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations
- *External matters that have occurred*—for example, legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood

## Consideration of Management's Plans

.07 If, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, he should consider management's plans for dealing with the adverse effects of the conditions and events. The auditor should obtain information about the plans and consider whether it is likely the adverse effects will be mitigated for a reasonable period of time and that such plans can be effectively implemented. The auditor's considerations relating to management plans may include the following:

- Plans to dispose of assets
  - Restrictions on disposal of assets, such as covenants limiting such transactions in loan or similar agreements or encumbrances against assets
  - Apparent marketability of assets that management plans to sell
  - Possible direct or indirect effects of disposal of assets

- Plans to borrow money or restructure debt
  - Availability of debt financing, including existing or committed credit arrangements, such as lines of credit or arrangements for factoring receivables or sale-leaseback of assets
  - Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity
  - Possible effects on management's borrowing plans of existing restrictions on additional borrowing or the sufficiency of available collateral
- Plans to reduce or delay expenditures
  - Apparent feasibility of plans to reduce overhead or administrative expenditures, to postpone maintenance or research and development projects, or to lease rather than purchase assets
  - Possible direct or indirect effects of reduced or delayed expenditures
- Plans to increase ownership equity
  - Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital
  - Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors

.08 When evaluating management's plans, the auditor should identify those elements that are particularly significant to overcoming the adverse effects of the conditions and events and should plan and perform auditing procedures to obtain evidential matter about them. For example, the auditor should consider the adequacy of support regarding the ability to obtain additional financing or the planned disposal of assets.

.09 When prospective financial information is particularly significant to management's plans, the auditor should request management to provide that information and should consider the adequacy of support for significant assumptions underlying that information. The auditor should give particular attention to assumptions that are—

- Material to the prospective financial information.
- Especially sensitive or susceptible to change.
- Inconsistent with historical trends.

The auditor's consideration should be based on knowledge of the entity, its business, and its management and should include (a) reading of the prospective financial information and the underlying assumptions and (b) comparing prospective financial information in prior periods with actual results and comparing prospective information for the current period with results achieved to date. If the auditor becomes aware of factors, the effects of which are not reflected in such prospective financial information, he should discuss those factors with management and, if necessary, request revision of the prospective financial information.

### **Consideration of Financial Statement Effects**

.10 When, after considering management's plans, the auditor concludes there is substantial doubt about the entity's ability to continue as a going

concern for a reasonable period of time, the auditor should consider the possible effects on the financial statements and the adequacy of the related disclosure. Some of the information that might be disclosed includes—

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- The possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).<sup>3</sup>
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

.11 When, primarily because of the auditor's consideration of management's plans, he concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time is alleviated, he should consider the need for disclosure of the principal conditions and events that initially caused him to believe there was substantial doubt. The auditor's consideration of disclosure should include the possible effects of such conditions and events, and any mitigating factors, including management's plans.

## Consideration of the Effects on the Auditor's Report

.12 If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion.<sup>4</sup> The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms substantial doubt *and* going concern] as illustrated in paragraph .13. [As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

.13 An example follows of an explanatory paragraph (following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these

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<sup>3</sup> It is not intended that such prospective financial information constitute prospective financial statements meeting the minimum presentation guidelines set forth in the Statement on Standards for Accountants' Services on Prospective Financial Information, *Financial Forecasts and Projections* [section 200], nor that the inclusion of such information require any consideration beyond that normally required by generally accepted auditing standards.

<sup>4</sup> The inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see section 508, *Reports on Audited Financial Statements*).

matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

.14 If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in section 508, *Reports on Audited Financial Statements*.

.15 Substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time that arose in the current period does not imply that a basis for such doubt existed in the prior period and, therefore, should not affect the auditor's report on the financial statements of the prior period that are presented on a comparative basis. When financial statements of one or more prior periods are presented on a comparative basis with financial statements of the current period, reporting guidance is provided in section 508.

.16 If substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time existed at the date of prior period financial statements that are presented on a comparative basis, and that doubt has been removed in the current period, the explanatory paragraph included in the auditor's report (following the opinion paragraph) on the financial statements of the prior period should not be repeated.

## Effective Date

.17 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

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## AU Section 342

# Auditing Accounting Estimates

Source: SAS No. 57.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards. For purposes of this section, an *accounting estimate* is an approximation of a financial statement element, item, or account. Accounting estimates are often included in historical financial statements because—

- a. The measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events.
- b. Relevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis.

.02 Accounting estimates in historical financial statements measure the effects of past business transactions or events, or the present status of an asset or liability. Examples of accounting estimates include net realizable values of inventory and accounts receivable, property and casualty insurance loss reserves, revenues from contracts accounted for by the percentage-of-completion method, and pension and warranty expenses.<sup>1</sup>

.03 Management is responsible for making the accounting estimates included in the financial statements. Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.

.04 The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors.

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<sup>1</sup> Additional examples of accounting estimates included in historical financial statements are presented in paragraph .16.

## Developing Accounting Estimates

**.05** Management is responsible for establishing a process for preparing accounting estimates. Although the process may not be documented or formally applied, it normally consists of—

- a. Identifying situations for which accounting estimates are required.
- b. Identifying the relevant factors that may affect the accounting estimate.
- c. Accumulating relevant, sufficient, and reliable data on which to base the estimate.
- d. Developing assumptions that represent management's judgment of the most likely circumstances and events with respect to the relevant factors.
- e. Determining the estimated amount based on the assumptions and other relevant factors.
- f. Determining that the accounting estimate is presented in conformity with applicable accounting principles and that disclosure is adequate.

The risk of material misstatement of accounting estimates normally varies with the complexity and subjectivity associated with the process, the availability and reliability of relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with the assumptions.

## Internal Control Structure Related to Accounting Estimates

**.06** An entity's internal control structure may reduce the likelihood of material misstatements of accounting estimates. Specific relevant aspects of that structure include the following:

- a. Management communication of the need for proper accounting estimates
- b. Accumulation of relevant, sufficient, and reliable data on which to base an accounting estimate
- c. Preparation of the accounting estimate by qualified personnel
- d. Adequate review and approval of the accounting estimates by appropriate levels of authority, including—
  1. Review of sources of relevant factors
  2. Review of development of assumptions
  3. Review of reasonableness of assumptions and resulting estimates
  4. Consideration of the need to use the work of specialists
  5. Consideration of changes in previously established methods to arrive at accounting estimates
- e. Comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates
- f. Consideration by management of whether the resulting accounting estimate is consistent with the operational plans of the entity.

## Evaluating Accounting Estimates

.07 The auditor's objective when evaluating accounting estimates is to obtain sufficient competent evidential matter to provide reasonable assurance that—

- a. All accounting estimates that could be material to the financial statements have been developed.
- b. Those accounting estimates are reasonable in the circumstances.
- c. The accounting estimates are presented in conformity with applicable accounting principles<sup>2</sup> and are properly disclosed.<sup>3</sup>

## Identifying Circumstances That Require Accounting Estimates

.08 In evaluating whether management has identified all accounting estimates that could be material to the financial statements, the auditor considers the circumstances of the industry or industries in which the entity operates, its methods of conducting business, new accounting pronouncements, and other external factors. The auditor should consider performing the following procedures:

- a. Consider assertions embodied in the financial statements to determine the need for estimates. (See paragraph .16 for examples of accounting estimates included in financial statements.)<sup>\*</sup>
- b. Evaluate information obtained in performing other procedures, such as—
  1. Information about changes made or planned in the entity's business, including changes in operating strategy, and the industry in which the entity operates that may indicate the need to make an accounting estimate (section 311, *Planning and Supervision*).
  2. Changes in the methods of accumulating information.
  3. Information concerning identified litigation, claims, and assessments (section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*), and other contingencies.
  4. Information from reading available minutes of meetings of stockholders, directors, and appropriate committees.
  5. Information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies.
- c. Inquire of management about the existence of circumstances that may indicate the need to make an accounting estimate.

## Evaluating Reasonableness

.09 In evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are—

- a. Significant to the accounting estimate.
- b. Sensitive to variations.

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<sup>2</sup> Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, discusses the auditor's responsibility for evaluating conformity with generally accepted accounting principles.

<sup>3</sup> Section 431, *Adequacy of Disclosure in Financial Statements*, discusses the auditor's responsibility to consider whether the financial statements include adequate disclosures of material matters in light of the circumstances and facts of which he is aware.

- c. Deviations from historical patterns.
- d. Subjective and susceptible to misstatement and bias.

The auditor normally should consider the historical experience of the entity in making past estimates as well as the auditor's experience in the industry. However, changes in facts, circumstances, or entity's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.<sup>4</sup>

.10 In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to completion of fieldwork.

.11 Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach:

- a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.
- b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.
- c. Consider whether there are additional key factors or alternative assumptions about the factors.
- d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose.
- f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
- g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions.

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<sup>4</sup> In addition to other evidential matter about the estimate, in certain instances, the auditor may wish to obtain written representation from management regarding the key factors and assumptions.



- h. Consider using the work of a specialist regarding certain assumptions (section 336, *Using the Work of a Specialist*).
- i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.

**.12 Develop an expectation.** Based on the auditor's understanding of the facts and circumstances, he may independently develop an expectation as to the estimate by using other key factors or alternative assumptions about those factors.

**.13 Review subsequent events or transactions.** Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the completion of fieldwork, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

**.14** As discussed in section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .29, the auditor evaluates the reasonableness of accounting estimates in relationship to the financial statements taken as a whole:

Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements. The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole.

## Effective Date

**.15** This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

## Appendix

### .16 Examples of Accounting Estimates

The following are examples of accounting estimates that are included in financial statements. The list is presented for information only. It should not be considered all-inclusive.

#### Receivables:

- Uncollectible receivables
- Allowance for loan losses
- Uncollectible pledges

#### Inventories:

- Obsolete inventory
- Net realizable value of inventories where future selling prices and future costs are involved
- Losses on purchase commitments

#### Financial instruments:

- Valuation of securities
- Trading versus investment security classification
- Probability of high correlation of a hedge
- Sales of securities with puts and calls

#### Productive facilities, natural resources and intangibles:

- Useful lives and residual values
- Depreciation and amortization methods
- Recoverability of costs
- Recoverable reserves

#### Accruals:

- Property and casualty insurance-company loss reserves
- Compensation in stock option plans and deferred plans
- Warranty claims
- Taxes on real and personal property
- Renegotiation refunds
- Actuarial assumptions in pension costs

#### Revenues:

- Airline passenger revenue
- Subscription income
- Freight and cargo revenue
- Dues income
- Losses on sales contracts

#### Contracts:

- Revenue to be earned
- Costs to be incurred
- Percent of completion

#### Leases:

- Initial direct costs
- Executory costs
- Residual values

#### Litigation:

- Probability of loss
- Amount of loss

#### Rates:

- Annual effective tax rate in interim reporting
- Imputed interest rates on receivables and payables
- Gross profit rates under program method of accounting

#### Other:

- Losses and net realizable value on disposal of segment or restructuring of a business
- Fair values in nonmonetary exchanges
- Interim period costs in interim reporting
- Current values in personal financial statements

## AU Section 350

### *Audit Sampling*

(Supersedes Statement on Auditing Standards No. 1, sections 320A, and 320B.)

Sources: SAS No. 39; SAS No. 43; SAS No. 45.

See section 9350 for interpretations of this section.

Effective for periods ended on or after June 25, 1983, unless otherwise indicated.

.01 Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.<sup>1</sup> This section provides guidance for planning, performing, and evaluating audit samples.

.02 The auditor often is aware of account balances and transactions that may be more likely to contain misstatements.<sup>2</sup> He considers this knowledge in planning his procedures, including audit sampling. The auditor usually will have no special knowledge about other account balances and transactions that, in his judgment, will need to be tested to fulfill his audit objectives. Audit sampling is especially useful in these cases.

.03 There are two general approaches to audit sampling: nonstatistical and statistical. Both approaches require that the auditor use professional

[The next page is 463-3.]

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<sup>1</sup> There may be other reasons for an auditor to examine less than 100 percent of the items comprising an account balance or class of transactions. For example, an auditor may examine only a few transactions from an account balance or class of transactions to (a) gain an understanding of the nature of an entity's operations or (b) clarify his understanding of the entity's internal control structure. In such cases, the guidance in this statement is not applicable.

<sup>2</sup> For purposes of this section the use of the term misstatement can include both errors and irregularities as appropriate for the design of the sampling application. Errors and irregularities are defined in section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraphs .02—.03.

judgment in planning, performing, and evaluating a sample and in relating the evidential matter produced by the sample to other evidential matter when forming a conclusion about the related account balance or class of transactions. The guidance in this section applies equally to nonstatistical and statistical sampling.

**.04** The third standard of field work states, “Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.” Either approach to audit sampling, when properly applied, can provide sufficient evidential matter.

**.05** The sufficiency of evidential matter is related to the design and size of an audit sample, among other factors. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. For a given objective, the efficiency of the sample relates to its design; one sample is more efficient than another if it can achieve the same objectives with a smaller sample size. In general, careful design can produce more efficient samples.

**.06** Evaluating the competence of evidential matter is solely a matter of auditing judgment and is not determined by the design and evaluation of an audit sample. In a strict sense, the sample evaluation relates only to the likelihood that existing monetary misstatements or deviations from prescribed internal control structure policies or procedures are proportionately included in the sample, not to the auditor’s treatment of such items. Thus, the choice of nonstatistical or statistical sampling does not directly affect the auditor’s decisions about the auditing procedures to be applied, the competence of the evidential matter obtained with respect to individual items in the sample, or the actions that might be taken in light of the nature and cause of particular misstatements.

## Uncertainty and Audit Sampling

**.07** Some degree of uncertainty is implicit in the concept of “a reasonable basis for an opinion” referred to in the third standard of field work. The justification for accepting some uncertainty arises from the relationship between such factors as the cost and time required to examine all of the data and the adverse consequences of possible erroneous decisions based on the conclusions resulting from examining only a sample of the data. If these factors do not justify the acceptance of some uncertainty, the only alternative is to examine all of the data. Since this is seldom the case, the basic concept of sampling is well established in auditing practice.

**.08** The uncertainty inherent in applying audit procedures is referred to as audit risk. Audit risk consists of (a) the risk (consisting of inherent risk and control risk) that the balance or class and related assertions contain misstatements that could be material to the financial statements when aggregated with misstatements in other balances or classes and (b) the risk (detection risk) that the auditor will not detect such misstatement. The risk of these adverse events occurring jointly can be viewed as a function of the respective individual risks. Using professional judgment, the auditor evaluates numerous factors to assess inherent risk and control risk (assessing control risk at less than the maximum level involves performing tests of controls), and performs

substantive tests (analytical procedures and test of details of account balances or classes of transactions) to restrict detection risk.

**.09** Audit risk includes both uncertainties due to sampling and uncertainties due to factors other than sampling. These aspects of audit risk are sampling risk and nonsampling risk, respectively. [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

**.10** Sampling risk arises from the possibility that, when a test of controls or a substantive test is restricted to a sample, the auditor's conclusions may be different from the conclusions he would reach if the test were applied in the same way to all items in the account balance or class of transactions. That is, a particular sample may contain proportionately more or less monetary misstatements or deviations from prescribed internal control structure policies or procedures than exist in the balance or class as a whole. For a sample of a specific design, sampling risk varies inversely with sample size: the smaller the sample size, the greater the sampling risk.

**.11** Nonsampling risk includes all the aspects of audit risk that are not due to sampling. An auditor may apply a procedure to all transactions or balances and still fail to detect a material misstatement. Nonsampling risk includes the possibility of selecting audit procedures that are not appropriate to achieve the specific objective. For example, confirming recorded receivables cannot be relied on to reveal unrecorded receivables. Nonsampling risk also arises because the auditor may fail to recognize misstatements included in documents that he examines, which would make that procedure ineffective even if he were to examine all items. Nonsampling risk can be reduced to a negligible level through such factors as adequate planning and supervision (see section 311, *Planning and Supervision*) and proper conduct of a firm's audit practice (see section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*). [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

## Sampling Risk

**.12** The auditor should apply professional judgment in assessing sampling risk. In performing substantive tests of details the auditor is concerned with two aspects of sampling risk:

- *The risk of incorrect acceptance* is the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated.
- *The risk of incorrect rejection* is the risk that the sample supports the conclusion that the recorded account balance is materially misstated when it is not materially misstated.

The auditor is also concerned with two aspects of sampling risk in performing tests of controls when sampling is used:

- *The risk of assessing control risk too low* is the risk that the assessed level of control risk based on the sample is less than the true operating effectiveness of the control structure policy or procedure.
- *The risk of assessing control risk too high* is the risk that the assessed level of control risk based on the sample is greater than the

true operating effectiveness of the control structure policy or procedure.

**.13** The risk of incorrect rejection and the risk of assessing control risk too high relate to the efficiency of the audit. For example, if the auditor's evaluation of an audit sample leads him to the initial erroneous conclusion that a balance is materially misstated when it is not, the application of additional audit procedures and consideration of other audit evidence would ordinarily lead the auditor to the correct conclusion. Similarly, if the auditor's evaluation of a sample leads him to unnecessarily assess control risk too high for an assertion, he would ordinarily increase the scope of substantive tests to compensate for the perceived ineffectiveness of the internal control structure policy or procedures. Although the audit may be less efficient in these circumstances, the audit is, nevertheless, effective.

**.14** The risk of incorrect acceptance and the risk of assessing control risk too low relate to the effectiveness of an audit in detecting an existing material misstatement. These risks are discussed in the following paragraphs.

## Sampling in Substantive Tests of Details

### Planning Samples

**.15** Planning involves developing a strategy for conducting an audit of financial statements. For general guidance on planning, see section 311, *Planning and Supervision*.

**.16** When planning a particular sample for a substantive test of details, the auditor should consider

- The relationship of the sample to the relevant audit objective (see section 326, *Evidential Matter*).
- Preliminary judgments about materiality levels.
- The auditor's allowable risk of incorrect acceptance.
- Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

**.17** When planning a particular sample, the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The auditor should determine that the population from which he draws the sample is appropriate for the specific audit objective. For example, an auditor would not be able to detect understatements of an account due to omitted items by sampling the recorded items. An appropriate sampling plan for detecting such understatements would involve selecting from a source in which the omitted items are included. To illustrate, subsequent cash disbursements might be sampled to test recorded accounts payable for understatement because of omitted purchases, or shipping documents might be sampled for understatement of sales due to shipments made but not recorded as sales.

**.18** Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his judgment of the monetary amount of misstatements that would be material. When planning a sample for a substantive test of details, the auditor should consider how much monetary misstate-

ment in the related account balance or class of transactions may exist without causing the financial statements to be materially misstated. This maximum monetary misstatement for the balance or class is called *tolerable misstatement* for the sample. Tolerable misstatement is a planning concept and is related to the auditor's preliminary judgments about materiality levels in such a way that tolerable misstatement, combined for the entire audit plan, does not exceed those estimates.

.19 The second standard of field work states, "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." After assessing and considering the levels of inherent and control risks, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed levels of inherent risk, control risk, and detection risk for other substantive procedures directed toward the same specific audit objective decreases, the auditor's allowable risk of incorrect acceptance for the substantive tests of details increases and, thus, the smaller the required sample size for the substantive tests of details. For example, if inherent and control risks are assessed at the maximum, and no other substantive tests directed toward the same specific audit objectives are performed, the auditor should allow for a low risk of incorrect acceptance for the substantive tests of details.<sup>3</sup> Thus, the auditor would select a larger sample size for the tests of details than if he allowed a higher risk of incorrect acceptance.

.20 The Appendix illustrates how the auditor may relate the risk of incorrect acceptance for a particular substantive test of details to his assessments of inherent risk, control risk, and the risk that analytical procedures and other relevant substantive tests would fail to detect material misstatement.

.21 As discussed in section 326, the sufficiency of tests of details for a particular account balance or class of transactions is related to the individual importance of the items examined as well as to the potential for material misstatement. When planning a sample for a substantive test of details, the auditor uses his judgment to determine which items, if any, in an account balance or class of transactions should be individually examined and which items, if any, should be subject to sampling. The auditor should examine those items for which, in his judgment, acceptance of some sampling risk is not justified. For example, these may include items for which potential misstatements could individually equal or exceed the tolerable misstatement. Any items that the auditor has decided to examine 100 percent are not part of the items subject to sampling. Other items that, in the auditor's judgment, need to be tested to fulfill the audit objective but need not be examined 100 percent, would be subject to sampling.

.22 The auditor may be able to reduce the required sample size by separating items subject to sampling into relatively homogeneous groups on the basis of some characteristic related to the specific audit objective. For example, common bases for such groupings are the recorded or book value of

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<sup>3</sup> Some auditors prefer to think of risk levels in quantitative terms. For example, in the circumstances described, an auditor might think in terms of a 5 percent risk of incorrect acceptance for the substantive test of details. Risk levels used in sampling applications in other fields are not necessarily relevant in determining appropriate levels for applications in auditing because an audit includes many interrelated tests and sources of evidence.

the items, the nature of internal control structure policies or procedures related to processing the items, and special considerations associated with certain items. An appropriate number of items is then selected from each group.

**.23** To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should consider the tolerable misstatement, the allowable risk of incorrect acceptance, and the characteristics of the population. An auditor applies professional judgment to relate these factors in determining the appropriate sample size. The Appendix illustrates the effect these factors may have on sample size.

### Sample Selection

**.24** Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. For example, random-based selection of items represents one means of obtaining such samples.<sup>4</sup>

### Performance and Evaluation

**.25** Auditing procedures that are appropriate to the particular audit objective should be applied to each sample item. In some circumstances the auditor may not be able to apply the planned audit procedures to selected sample items because, for example, supporting documentation may be missing. The auditor's treatment of unexamined items will depend on their effect on his evaluation of the sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class contains material misstatement, the auditor should consider alternative procedures that would provide him with sufficient evidence to form a conclusion. The auditor should also consider whether the reasons for his inability to examine the items have implications in relation to his planned assessed level of control risk or his degree of reliance on management representations.

**.26** The auditor should project the misstatement results of the sample to the items from which the sample was selected.<sup>5, 6</sup> There are several acceptable ways to project misstatements from a sample. For example, an auditor may have selected a sample of every twentieth item (50 items) from a population containing one thousand items. If he discovered overstatements of \$3,000 in that sample, the auditor could project a \$60,000 overstatement by dividing the amount of misstatement in the sample by the fraction of total items from the population included in the sample. The auditor should add that projection to the misstatements discovered in any items examined 100 percent. This total

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<sup>4</sup> Random-based selection includes, for example, random sampling, stratified random sampling, sampling with probability proportional to size, and systematic sampling (for example, every hundredth item) with one or more random starts.

<sup>5</sup> If the auditor has separated the items subject to sampling into relatively homogeneous groups (see paragraph .22), he separately projects the misstatement results of each group and sums them.

<sup>6</sup> See section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraphs .22—.25, for a further discussion of the auditor's consideration of differences between the accounting records and the underlying facts and circumstances. This section provides specific guidance on the auditor's consideration of an audit adjustment that is, or may be, an irregularity.



projected misstatement should be compared with the tolerable misstatement for the account balance or class of transactions, and appropriate consideration should be given to sampling risk. If the total projected misstatement is less than tolerable misstatement for the account balance or class of transactions, the auditor should consider the risk that such a result might be obtained even though the true monetary misstatement for the population exceeds tolerable misstatement. For example, if the tolerable misstatement in an account balance of \$1 million is \$50,000 and the total projected misstatement based on an appropriate sample (see paragraph .23) is \$10,000, he may be reasonably assured that there is an acceptably low sampling risk that the true monetary misstatement for the population exceeds tolerable misstatement. On the other hand, if the total projected misstatement is close to the tolerable misstatement, the auditor may conclude that there is an unacceptably high risk that the actual misstatements in the population exceed the tolerable misstatement. An auditor uses professional judgment in making such evaluations.

**.27** In addition to the evaluation of the frequency and amounts of monetary misstatements, consideration should be given to the qualitative aspects of the misstatements. These include (a) the nature and cause of misstatements, such as whether they are differences in principle or in application, are errors or irregularities, or are due to misunderstanding of instructions or to carelessness, and (b) the possible relationship of the misstatements to other phases of the audit. The discovery of an irregularity ordinarily requires a broader consideration of possible implications than does the discovery of an error.

**.28** If the sample results suggest that the auditor's planning assumptions were incorrect, he should take appropriate action. For example, if monetary misstatements are discovered in a substantive test of details in amounts or frequency that is greater than is consistent with the assessed levels of inherent and control risk, the auditor should alter his risk assessments. The auditor should also consider whether to modify the other audit tests that were designed based upon the inherent and control risk assessments. For example, a large number of misstatements discovered in confirmation of receivables may indicate the need to reconsider the control risk assessment related to the assertions that impacted the design of substantive tests of sales or cash receipts.

**.29** The auditor should relate the evaluation of the sample to other relevant audit evidence when forming a conclusion about the related account balance or class of transactions.

**.30** Projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications should be considered in the aggregate along with other relevant audit evidence when the auditor evaluates whether the financial statements taken as a whole may be materially misstated.

## **Sampling in Tests of Controls**

### **Planning Samples**

**.31** When planning a particular audit sample for a test of controls, the auditor should consider

- The relationship of the sample to the objective of the test of controls.
- The maximum rate of deviations from prescribed internal control structure policies or procedures that would support his planned assessed level of control risk.
- The auditor's allowable risk of assessing control risk too low.
- Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

.32 For many tests of controls, sampling does not apply. Procedures performed to obtain an understanding of the internal control structure sufficient to plan an audit do not involve sampling.<sup>7</sup> Sampling generally is not applicable to tests of internal control structure policies or procedures that depend primarily on appropriate segregation of duties or that otherwise provide no documentary evidence of performance. In addition, sampling may not apply to tests of certain documented internal control structure policies or procedures. Sampling may not apply to tests directed toward obtaining evidence about the design or operation of the control environment or the accounting system. For example, inquiry or observation of explanation of variances from budgets when the auditor does not desire to estimate the rate of deviation from the prescribed control structure policy or procedure.

.33 When designing samples for tests of controls the auditor ordinarily should plan to evaluate operating effectiveness in terms of deviations from prescribed internal control structure policies or procedures, as to either the rate of such deviations or the monetary amount of the related transactions.<sup>8</sup> In this context, pertinent internal control structure policies or procedures are ones that, had they not been included in the design of the internal control structure would have adversely affected the auditor's planned assessed level of control risk. The auditor's overall assessment of control risk for a particular assertion involves combining judgments about the prescribed control structure policies or procedures, the deviations from prescribed policies or procedures, and the degree of assurance provided by the sample and other tests of controls.

.34 The auditor should determine the maximum rate of deviations from the prescribed internal control structure policy and procedure that he would be willing to accept without altering his planned assessed level of control risk. This is the *tolerable rate*. In determining the tolerable rate, the auditor should consider (a) the planned assessed level of control risk, and (b) the degree of assurance desired by the evidential matter in the sample. For example, if the auditor plans to assess control risk at a low level, and he desires a high degree of assurance from the evidential matter provided by the sample for tests of controls (i.e., not perform other tests of controls for the assertion), he might decide that a tolerable rate of 5 percent or possibly less would be reasonable. If the auditor either plans to assess control risk at a higher level, or he desires assurance from other tests of controls along with that provided by the sample (such as inquiries of appropriate entity personnel or observation of the

<sup>7</sup> The auditor often plans to perform tests of controls concurrently with obtaining an understanding of the internal control structure (see section 319.41) for the purpose of estimating the rate of deviation from the prescribed internal control structure policies or procedures, as to either the rate of such deviations or monetary amount of the related transactions. Sampling, as defined in this section, applies to such tests of controls.

<sup>8</sup> For simplicity the remainder of this section will refer to only the rate of deviations.

application of the policy or procedure), the auditor might decide that a tolerable rate of 10 percent or more is reasonable.

**.35** In assessing the tolerable rate of deviations, the auditor should consider that, while deviations from pertinent control structure policies or procedures increase the risk of material misstatements in the accounting records, such deviations do not necessarily result in misstatements. For example, a recorded disbursement that does not show evidence of required approval may nevertheless be a transaction that is properly authorized and recorded. Deviations would result in misstatements in the accounting records only if the deviations and the misstatements occurred on the same transactions. Deviations from pertinent control procedures at a given rate ordinarily would be expected to result in misstatements at a lower rate.

**.36** In some situations, the risk of material misstatement for an assertion may be related to a combination of internal control structure policies or procedures. If a combination of two or more internal control structure policies or procedures is necessary to affect the risk of material misstatement for an assertion, those policies or procedures should be regarded as a single procedure, and deviations from any policies or procedures in combination should be evaluated on that basis.

**.37** Samples taken to test the operating effectiveness of internal control structure policies or procedures are intended to provide a basis for the auditor to conclude whether the control policies or procedures are being applied as prescribed. When the degree of assurance desired by the evidential matter in the sample is high, the auditor should allow for a low level of sampling risk (that is, the risk of assessing control risk too low).<sup>9</sup>

**.38** To determine the number of items to be selected for a particular sample for a test of controls, the auditor should consider the tolerable rate of deviation from the control structure policies or procedures being tested, the likely rate of deviations, and the allowable risk of assessing control risk too low. An auditor applies professional judgment to relate these factors in determining the appropriate sample size.

## Sample Selection

**.39** Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. Random-based selection of items represents one means of obtaining such samples. Ideally, the auditor should use a selection method that has the potential for selecting items from the entire period under audit. Section 319.55 provides guidance applicable to the auditor's use of sampling during interim and remaining periods.

## Performance and Evaluation

**.40** Auditing procedures that are appropriate to achieve the objective of the test of controls should be applied to each sample item. If the auditor is not able to apply the planned audit procedures or appropriate alternative procedures to selected items, he should consider the reasons for this limitation, and

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<sup>9</sup> The auditor who prefers to think of risk levels in quantitative terms might consider, for example, a 5 percent to 10 percent risk of assessing control risk too low.

he should ordinarily consider those selected items to be deviations from the prescribed policy or procedure for the purpose of evaluating the sample.

**.41** The deviation rate in the sample is the auditor's best estimate of the deviation rate in the population from which it was selected. If the estimated deviation rate is less than the tolerable rate for the population, the auditor should consider the risk that such a result might be obtained even though the true deviation rate for the population exceeds the tolerable rate for the population. For example, if the tolerable rate for a population is 5 percent and no deviations are found in a sample of 60 items, the auditor may conclude that there is an acceptably low sampling risk that the true deviation rate in the population exceeds the tolerable rate of 5 percent. On the other hand, if the sample includes, for example, two or more deviations, the auditor may conclude that there is an unacceptably high sampling risk that the rate of deviations in the population exceeds the tolerable rate of 5 percent. An auditor applies professional judgment in making such an evaluation.

**.42** In addition to the evaluation of the frequency of deviations from pertinent procedures, consideration should be given to the qualitative aspects of the deviations. These include (a) the nature and cause of the deviations, such as whether they are errors or irregularities or are due to misunderstanding of instructions or to carelessness, and (b) the possible relationship of the deviations to other phases of the audit. The discovery of an irregularity ordinarily requires a broader consideration of possible implications than does the discovery of an error.

**.43** If the auditor concludes that the sample results do not support the planned assessed level of control risk for an assertion, he should reevaluate the nature, timing, and extent of substantive procedures based on a revised consideration of the assessed level of control risk for the relevant financial statement assertions.

## Dual-Purpose Samples

**.44** In some circumstances the auditor may design a sample that will be used for dual purposes: assessing control risk and testing whether the recorded monetary amount of transactions is correct. In general, an auditor planning to use a dual-purpose sample would have made a preliminary assessment that there is an acceptably low risk that the rate of deviations from the prescribed internal control structure policy or procedure in the population exceeds the tolerable rate. For example, an auditor designing a test of a control procedure over entries in the voucher register may plan a related substantive test at a risk level that anticipates an assessment level of control risk below the maximum. The size of a sample designed for dual purposes should be the larger of the samples that would otherwise have been designed for the two separate purposes. In evaluating such tests, deviations from pertinent procedures and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

## Selecting a Sampling Approach

**.45** As discussed in paragraph .04, either a nonstatistical or statistical approach to audit sampling, when properly applied, can provide sufficient evidential matter.

**.46** Statistical sampling helps the auditor (a) to design an efficient sample, (b) to measure the sufficiency of the evidential matter obtained, and (c) to evaluate the sample results. By using statistical theory, the auditor can quantify sampling risk to assist himself in limiting it to a level he considers acceptable. However, statistical sampling involves additional costs of training auditors, designing individual samples to meet the statistical requirements, and selecting the items to be examined. Because either nonstatistical or statistical sampling can provide sufficient evidential matter, the auditor chooses between them after considering their relative cost and effectiveness in the circumstances.

### **Effective Date**

**.47** This section is effective for audits of financial statements for periods ended on or after June 25, 1983. Earlier application is encouraged. [As amended, effective retroactively to June 25, 1982, by Statement on Auditing Standards No. 43.]

## **.48 Appendix**

### **Relating the Risk of Incorrect Acceptance for a Substantive Test of Details to Other Sources of Audit Assurance**

1. Audit risk, with respect to a particular account balance or class of transactions, is the risk that there is a monetary misstatement greater than tolerable misstatement affecting an assertion in an account balance or class of transactions that the auditor fails to detect. The auditor uses professional judgment in determining the allowable risk for a particular audit after he consider such factors as the risk of material misstatement in the financial statements, the cost to reduce the risk, and the effect of the potential misstatements on the use and understanding of the financial statements.

2. An auditor assesses inherent and control risk, and plans and performs substantive tests (analytical procedures and substantive tests of details) in whatever combination to reduce audit risk to an appropriate level. However, the second standard of field work contemplates that ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transactions classes.

3. The sufficiency of audit sample sizes, whether nonstatistical or statistical, is influenced by several factors. Table 1 illustrates how several of these factors may affect sample sizes for a substantive tests of details. Factors a, b and c in table 1 should be considered together (See paragraph .08). For example, high inherent risk, the lack of effective internal control structure policies or procedures, and the absence of other substantive tests related to the same audit objective ordinarily require larger sample sizes for related substantive tests of details than if there were other sources to provide the basis for assessing inherent or control risks below the maximum, or if other substantive tests related to the same objective were performed. Alternatively, low inherent risk, effective internal control structure policies and procedures, or effective analytical procedures and other relevant substantive tests may lead the auditor to conclude that the sample, if any, needed for an additional test of details can be small.

4. The following model expresses the general relationship of the risks associated with the auditor's assessment of inherent and control risks, and the effectiveness of analytical procedures (including other relevant substantive tests) and substantive tests of details. The model is not intended to be a mathematical formula including all factors that may influence the determination of individual risk components; however, some auditors find such a model to be useful when planning appropriate risk levels for audit procedures to achieve the auditor's desired audit risk.

$$AR = IR \times CR \times AP \times TD$$

An auditor might use this model to obtain an understanding of an appropriate risk of incorrect acceptance for a substantive test of details as follows:

$$TD = AR / (IR \times CR \times AP)$$

AR = The allowable audit risk that monetary misstatements equal to tolerable misstatement might remain undetected for the account

balance or class of transactions and related assertions after the auditor has completed all audit procedures deemed necessary.<sup>1</sup> The auditor uses his professional judgment to determine the allowable audit risk after considering factors such as those discussed in paragraph 1 of this appendix.

**IR** = Inherent risk is the susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures.

**CR** = Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure policies and procedures. The auditor may assess control risk at the maximum, or assess control risk below the maximum based on the sufficiency of evidential matter obtained to support the effectiveness of internal control structure policies or procedures. The quantification for this model relates to the auditor's evaluation of the overall effectiveness of those internal control structure policies or procedures that would prevent or detect material misstatements equal to tolerable misstatement in the related account balance or class of transactions. For example, if the auditor believes that pertinent control structure policies or procedures would prevent or detect misstatements equal to tolerable misstatement about half the time, he would assess this risk as 50 percent. (CR is not the same as the risk of assessing control risk too low.)

**AP** = The auditor's assessment of the risk that analytical procedures and other relevant substantive tests would fail to detect misstatements that could occur in an assertion equal to tolerable misstatement, given that such misstatements occur and are not detected by the internal control structure.

**TD** = The allowable risk of incorrect acceptance for the substantive test of details, given that misstatements equal to tolerable misstatement occur in an assertion and are not detected by the internal control structure or analytical procedures and other relevant substantive tests.

5. The auditor planning a statistical sample can use the relationship in paragraph 4 of this Appendix to assist in planning his allowable risk of incorrect acceptance for a specific substantive test of details. To do so, he selects an acceptable audit risk (AR), and substantively quantifies his judgment of risks IR, CR and AP. Some levels of these risks are implicit in evaluating audit evidence and reaching conclusions. Auditors using the relationship prefer to evaluate these judgment risks explicitly.

6. The relationships between these independent risks are illustrated in table 2. In table 2 it is assumed, for illustrative purposes, that the auditor has chosen an audit risk of 5 percent for an assertion where inherent risk has been assessed at the maximum. Table 2 incorporates the premise that no internal control structure can be expected to be completely effective in detecting

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<sup>1</sup> For purposes of this Appendix, the nonsampling risk aspect of audit risk is assumed to be negligible, based on the level of quality controls in effect. [Footnote amended August, 1983, by Statement on Auditing Standards No. 45] (See section 313.)

aggregate misstatements equal to tolerable misstatement that might occur. The table also illustrates the fact that the risk level for substantive tests for particular assertions is not an isolated decision. Rather, it is a direct consequence of the auditor's assessments of inherent and control risks, and judgments about the effectiveness of analytical procedures and other relevant substantive tests, and it cannot be properly considered out of this context. [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

**Table 1**

**Factors Influencing Sample Sizes for a  
Substantive Test of Details in Sample Planning**

<i>Factor</i>	<i>Conditions leading to</i>		<i>Related factor for substantive sample planning</i>
	<i>Smaller sample size</i>	<i>Larger sample size</i>	
a. Assessment of inherent risk.	Low assessed level of inherent risk.	High assessed level of inherent risk.	Allowable risk of incorrect acceptance.
b. Assessment of control risk.	Low assessed level of control risk.	High assessed level of control risk.	Allowable risk of incorrect acceptance.
c. Assessment of risk for other substantive tests related to the same assertion (including analytical procedures and other relevant substantive tests).	Low assessment of risk associated with other relevant substantive tests.	High assessment of risk associated with other relevant substantive tests.	Allowable risk of incorrect acceptance.
d. Measure of tolerable misstatement for a specific account.	Larger measure of tolerable misstatement.	Smaller measure of tolerable misstatement.	Tolerable misstatement.
e. Expected size and frequency of misstatements.	Smaller misstatements or lower frequency.	Larger misstatements or higher frequency.	Assessment of population characteristics.
f. Number of items in the population.	Virtually no effect on sample size unless population is very small.		



**Table 2**

**Allowable Risk of Incorrect Acceptance (TD)  
for Various Assessments of CR and AP; for AR = .05 and IR = 1.0**

Auditor's subjective assessment of control risk.	Auditor's subjective assessment of risk that analytical procedures and other relevant substantive tests might fail to detect aggregate misstatements equal to tolerable misstatement.			
	<i>AP</i>			
	<i>10%</i>	<i>30%</i>	<i>50%</i>	<i>100%</i>
	<i>TD</i>			
<i>CR</i>				
10%	*	*	*	50%
30%	*	55%	33%	16%
50%	*	33%	20%	10%
100%	50%	16%	10%	5%

\* The allowable level of AR of 5 percent exceeds the product of IR, CR, and AP, and thus, the planned substantive test of details may not be necessary.

NOTE: The table entries for TD are computed from the illustrated model: TD equals  $AR/(IR \times CR \times AP)$ . For example, for IR = 1.0, CR = .50, AP = .30, TD =  $.05/(1.0 \times .50 \times .30)$  or .33 (equals 33%).

[The next page is 463-21.]

**AU Section 9350*****Audit Sampling: Auditing Interpretations of Section 350*****1. Applicability**

**.01 Question**—Section 350, *Audit Sampling*, paragraph .01, footnote 1, states that there may be reasons other than sampling for an auditor to examine less than 100 percent of the items comprising an account balance or class of transactions. For what reasons might an auditor's examination of less than 100 percent of the items comprising an account balance or class of transactions *not* be considered audit sampling?

**.02 Answer**—The auditor's examination of less than 100 percent of the items comprising an account balance or class of transactions would not be considered to be an audit sampling application under the following circumstances.

**a.** *It is not the auditor's intent to extend the conclusion that he reaches by examining the items to the remainder of the items in the account balance or class.* Audit sampling is defined as the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class. Thus, if the purpose of the auditor's application of an auditing procedure to less than 100 percent of the items in an account balance or class of transactions is something other than evaluating a trait of the entire balance or class, he is not using audit sampling.

For example, an auditor might trace several transactions through an entity's accounting system to gain an understanding of the nature of the entity's operations or clarify his understanding of the design of the entity's internal control structure. In such cases the auditor's intent is to gain a general understanding of the accounting system or other relevant parts of the internal control structure, rather than the evaluation of a characteristic of all transactions processed. As a result, the auditor is not using audit sampling.

Occasionally auditors perform procedures such as checking arithmetical calculations or tracing journal entries into ledger accounts on a test basis. When such procedures are applied to less than 100 percent of the arithmetical calculations or ledger postings that affect the financial statements, audit sampling may not be involved if the procedure is not a test to evaluate a characteristic of an account balance or class of transactions, but is intended only to provide limited knowledge that supplements the auditor's other evidential matter regarding a financial statement assertion.

**b.** *Although he might not be examining all the items in an account balance or class of transactions, the auditor might be examining 100 percent of the items in a given population.* A "population" for audit sampling purposes does not necessarily need to be an entire account balance or class of transactions. For example, in some circumstances, an auditor might examine all of the items that comprise an account balance or class of transactions that exceed a given amount or that have an

unusual characteristic and either apply other auditing procedures (e.g., analytical procedures) to those items that do not exceed the given amount or possess the unusual characteristic or apply no auditing procedures to them because of their insignificance. Again, the auditor is not using audit sampling. Rather, he has broken the account balance or class of transactions into two groups. One group is tested 100 percent, the other group is either tested by analytical procedures or considered insignificant. The auditor would be using audit sampling only if he applied an auditing procedure to less than all of the items in the second group to form a conclusion about that group. For the same reason, cutoff tests often do not involve audit sampling applications. In performing cutoff tests auditors often examine all significant transactions for a period surrounding the cutoff date and, as a result, such tests do not involve the application of audit sampling.

c. *The auditor is testing internal control structure policies and procedures that are not documented.* Auditors choose from a variety of methods including inquiry, observation, and examination of documentary evidence in testing internal control structure policies and procedures. For example, observation of a client's physical inventory count procedures is a test that is performed primarily through the auditor's observation of controls over such things as inventory movement, counting procedures and other procedures used by the client to control the count of the inventory. The procedures that the auditor uses to observe the client's physical inventory count generally do not require use of audit sampling. However, audit sampling may be used in certain tests of controls or substantive tests of details of inventory, for example, in tracing selected test counts into inventory records.

d. *The auditor is not performing a substantive test of details.* Substantive tests consist of tests of details of transactions and balances, analytical review and or from a combination of both. In performing substantive tests, audit sampling is generally used only in testing details of transactions and balances.

[Issue Date: January, 1985.]

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## AU Section 380

### ***Communication With Audit Committees***

Source: SAS No. 61.

**Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.**

.01 This section establishes a requirement for the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process.<sup>1</sup> For purposes of this document, the recipient of the communications is referred to as the *audit committee*. The communications required by this section are applicable to (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and (2) all Securities and Exchange Commission (SEC) engagements.<sup>2</sup>

.02 This section requires the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and

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<sup>1</sup> Communication with the audit committee by the independent auditor on certain specified matters when they arise in the conduct of an audit is required by other standards, including—

- Section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit*.
- Section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.
- Section 317, *Illegal Acts by Clients*.
- Section 722, *Interim Financial Information*.

This section does not modify the requirements of these standards.

<sup>2</sup> For purposes of this section, an SEC engagement is defined as one that involves the audit of the financial statements of—

1. An issuer making an initial filing, including amendments, under the Securities Act of 1933 and the Securities Exchange Act of 1934.
2. A registrant that files periodic reports with the SEC under the Investment Company Act of 1940 or the Securities Exchange Act of 1934 (except a broker or dealer registered only because of section 15(a) of the 1934 Act).
3. A bank or other lending institution that files periodic reports with the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Federal Home Loan Bank Board because the powers, functions, and duties of the SEC to enforce its periodic reporting provisions are vested, pursuant to section 12(i) of the 1934 Act, in those agencies. (Section 12(g) of the Securities Exchange Act of 1934 provides an exemption from periodic reporting to the SEC to [1] entities with less than \$5 million in total assets on the last day of each of the entity's three most recent fiscal years and fewer than 500 shareholders and [2] entities with fewer than 300 shareholders. Accordingly, such entities are not encompassed within the scope of this definition.)
4. A company whose financial statements appear in the annual report or proxy statement of any investment fund because it is a sponsor or manager of such a fund, but which is not itself a registrant required to file periodic reports under the 1940 Act or section 13 or 15(d) of the Securities Exchange Act of 1934.

disclosure process for which management is responsible. This section does not require communications with management; however, it does not *preclude* communications with management or other individuals within the entity who may, in the auditor's judgment, benefit from the communications.

.03 The communications may be oral or written. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers. When the auditor communicates in writing, the report should indicate that it is intended solely for the use of the audit committee or the board of directors and, if appropriate, management.

.04 The communications specified by this section are incidental to the audit. Accordingly, they are not required to occur before the issuance of the auditor's report on the entity's financial statements so long as the communications occur on a timely basis. There may be occasions, however, when discussion of certain of the matters (specified by paragraphs .06 through .14 below) with the audit committee prior to the issuance of the report may, in the auditor's judgment, be desirable.

.05 It may be appropriate for management to communicate to the audit committee certain of the matters specified in this section. In such circumstances, the auditor should be satisfied that such communications have, in fact, occurred. Generally, it is not necessary to repeat the communication of recurring matters each year. Periodically, however, the auditor should consider whether, because of changes in the audit committee or simply because of the passage of time, it is appropriate and timely to report such matters. Finally, this section is not intended to restrict the communication of other matters.

## **Matters to Be Communicated**

### **The Auditor's Responsibility Under Generally Accepted Auditing Standards**

.06 An audit performed in accordance with generally accepted auditing standards may address many matters of interest to an audit committee. For example, an audit committee is usually interested in the internal control structure and in whether the financial statements are free of material misstatement. In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed for these matters under generally accepted auditing standards. It is also important for the audit committee to understand that an audit conducted in accordance with generally accepted auditing standards is designed to obtain reasonable, rather than absolute, assurance about the financial statements.

### **Significant Accounting Policies**

.07 The auditor should determine that the audit committee is informed about the initial selection of and changes in significant accounting policies or their application. The auditor should also determine that the audit committee is informed about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. For example, significant accounting issues may exist in areas such as revenue recognition, off-balance-sheet financing, and accounting for equity investments.

## Management Judgments and Accounting Estimates

.08 Accounting estimates are an integral part of the financial statements prepared by management and are based upon management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

## Significant Audit Adjustments

.09 The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements that, in the auditor's judgment, may not have been detected except through the auditing procedures performed. Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.

## Other Information in Documents Containing Audited Financial Statements

.10 The audit committee often considers information prepared by management that accompanies the entity's financial statements. An example of information of this nature would be the "Management's Discussion and Analysis of Financial Condition and Results of Operations" that certain entities that file reports with the SEC are required to present in annual reports to shareholders. Section 550, *Other Information in Documents Containing Audited Financial Statements*, establishes the auditor's responsibility for such information.<sup>3</sup> The auditor should discuss with the audit committee his responsibility for other information in documents containing audited financial statements, any procedures performed, and the results.

## Disagreements With Management

.11 Disagreements with management may occasionally arise over the application of accounting principles to the entity's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the entity's financial statements, and the wording of the auditor's report. The auditor should discuss with the audit committee any disagreements with management,<sup>4</sup> whether or not satisfactorily resolved,

<sup>3</sup> Guidance on the auditor's consideration of other information is also provided by section 558, *Required Supplementary Information*; section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and section 711, *Filings Under Federal Securities Statutes*.

<sup>4</sup> The glossary to Financial Accounting Standards Board (FASB) Statement No. 57, *Related Party Disclosures* [AC section R36], defines management as follows:

Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief

about matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report. For purposes of this section, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

### **Consultation With Other Accountants**

.12 In some cases, management may decide to consult with other accountants about auditing and accounting matters. When the auditor is aware that such consultation has occurred, he should discuss with the audit committee his views about significant matters that were the subject of such consultation.<sup>5</sup>

### **Major Issues Discussed With Management Prior to Retention**

.13 The auditor should discuss with the audit committee any major issues that were discussed with management in connection with the initial or recurring retention of the auditor including, among other matters, any discussions regarding the application of accounting principles and auditing standards.

### **Difficulties Encountered in Performing the Audit**

.14 The auditor should inform the audit committee of any serious difficulties he encountered in dealing with management related to the performance of the audit. This may include, among other things, unreasonable delays by management in permitting the commencement of the audit or in providing needed information, and whether the timetable set by management was unreasonable under the circumstances. Other matters that the auditor may encounter include the unavailability of client personnel and the failure of client personnel to complete client-prepared schedules on a timely basis. If the auditor considers these matters significant, he should inform the audit committee.

### **Effective Date**

.15 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

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(Footnote Continued)

executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy-making functions. Persons without formal titles also may be members of management.

<sup>5</sup> Circumstances in which the auditor should be informed of such consultations are described in section 625, *Reports on the Application of Accounting Principles*, paragraph .07.

**AU Section 390*****Consideration of Omitted  
Procedures After the  
Report Date***

Source: SAS No. 46.

Effective, unless otherwise indicated: October 31, 1983.

.01 This section provides guidance on the considerations and procedures to be applied by an auditor who, subsequent to the date of his report on audited financial statements, concludes that one or more auditing procedures considered necessary at the time of the audit in the circumstances then existing were omitted from his audit of the financial statements, but there is no indication that those financial statements are not fairly presented in conformity with generally accepted accounting principles or with another comprehensive basis of accounting.<sup>1</sup> This circumstance should be distinguished from that described in section 561, which applies if an auditor, subsequent to the date of his report on audited financial statements, becomes aware that facts regarding those financial statements may have existed at that date that might have affected his report had he then been aware of them.

.02 Once he has reported on audited financial statements, an auditor has no responsibility to carry out any retrospective review of his work. However, reports and working papers relating to particular engagements may be subjected to postissuance review in connection with a firm's internal inspection program,<sup>2</sup> peer review, or otherwise, and the omission of a necessary auditing procedure may be disclosed.

.03 A variety of conditions might be encountered in which an auditing procedure considered necessary at the time of the audit in the circumstances then existing has been omitted; therefore, the considerations and procedures described herein necessarily are set forth only in general terms. The period of time during which the auditor considers whether this section applies to the circumstances of a particular engagement and then takes the actions, if any, that are required hereunder may be important. Because of legal implications that may be involved in taking the actions contemplated herein, the auditor would be well advised to consult with his attorney when he encounters the circumstances to which this section may apply, and, with the attorney's advice and assistance, determine an appropriate course of action.

.04 When the auditor concludes that an auditing procedure considered necessary at the time of the audit in the circumstances then existing was

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<sup>1</sup> The provisions of this section are not intended to apply to an engagement in which an auditor's work is at issue in a threatened or pending legal proceeding or regulatory investigation. (A *threatened legal proceeding* means that a potential claimant has manifested to the auditor an awareness of, and present intention to assert, a possible claim.)

<sup>2</sup> See section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*, paragraph .02, and related quality control standards regarding the quality control function of inspection.



omitted from his audit of financial statements, he should assess the importance of the omitted procedure to his present ability to support his previously expressed opinion regarding those financial statements taken as a whole. A review of his working papers, discussion of the circumstances with engagement personnel and others, and a reevaluation of the overall scope of his audit may be helpful in making this assessment. For example, the results of other procedures that were applied may tend to compensate for the one omitted or make its omission less important. Also, subsequent audits may provide audit evidence in support of the previously expressed opinion.

**.05** If the auditor concludes that the omission of a procedure considered necessary at the time of the audit in the circumstances then existing impairs his present ability to support his previously expressed opinion regarding the financial statements taken as a whole, and he believes there are persons currently relying, or likely to rely, on his report, he should promptly undertake to apply the omitted procedure or alternative procedures that would provide a satisfactory basis for his opinion.

**.06** When as a result of the subsequent application of the omitted procedure or alternative procedures, the auditor becomes aware that facts regarding the financial statements existed at the date of his report that would have affected that report had he been aware of them, he should be guided by the provisions of section 561.05—.09.

**.07** If in the circumstances described in paragraph .05, the auditor is unable to apply the previously omitted procedure or alternative procedures, he should consult his attorney to determine an appropriate course of action concerning his responsibilities to his client, regulatory authorities, if any, having jurisdiction over the client, and persons relying, or likely to rely, on his report.

## **Effective Date**

**.08** This section is effective as of October 31, 1983.

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## AU Section 400

# THE FIRST, SECOND, AND THIRD STANDARDS OF REPORTING

... adherence to principles ... meaning of present  
fairly ... consistency ... adequacy of disclosure  
... segment information ...

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**AU Section 410*****Adherence to Generally Accepted Accounting Principles***

Sources: SAS No. 1, section 410; SAS No. 62.

See section 9410 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The first standard of reporting is:

The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

.02 The term “generally accepted accounting principles” as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them. The first reporting standard is construed not to require a statement of fact by the auditor but an opinion as to whether the financial statements are presented in conformity with such principles.<sup>1</sup> If limitations on the scope of the audit make it impossible for the auditor to form an opinion as to such conformity, appropriate qualification of his report is required. [Amended by Statement on Auditing Standards No. 14, effective with respect to engagements to issue special reports on data for periods beginning after December 31, 1976.]

[.03—.04] [Superseded July 1975 by Statement on Auditing Standards No. 5, as superseded by section 411.]

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[The next page is 483.]

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<sup>1</sup> When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the first standard of reporting is satisfied by disclosing in the auditor's report that the statements have been prepared in conformity with another comprehensive basis of accounting other than generally accepted accounting principles and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used (see section 623, *Special Reports*, paragraphs .02—.10).

## AU Section 9410

# ***Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of Section 410***

### **[1.] Accounting Principles Recommended by Trade Associations <sup>[1]</sup>**

[.01—.03] [Withdrawn August, 1982 by Statement on Auditing Standards No. 43.]

### **[2.] The Impact of FASB Statement No. 2 on Auditor's Report Issued Prior to the Statement's Effective Date<sup>2</sup>**

[.04—.12] [Superseded October, 1979 by Interpretation No. 3, paragraphs .13-.19.]

### **3. The Impact on an Auditor's Report of an FASB Statement Prior to the Statement's Effective Date**

**.13 Question**—What is the impact on the auditor's report when he is reporting on financial statements issued before the effective date of a Statement of Financial Accounting Standards and the financial statements will have to be restated in the future because the FASB statement will require retroactive application of its provisions by prior period adjustment?

**.14 Interpretation**—In considering whether financial statements are presented in conformity with generally accepted accounting principles (GAAP), section 411.10 states: "The auditor should be familiar with alternative accounting principles that may be applicable to the transaction or facts under consideration and realize that *an accounting principle may have only limited usage but still have general acceptance.*" (Italics added.) [Reference changed by the issuance of Statement on Auditing Standards No. 43.]\*

**.15** For example, Financial Accounting Standards Board Statement No. 2 [AC section R50], *Accounting for Research and Development Costs*, was issued in October 1974, but was effective for fiscal years beginning on or after January 1, 1975. This Statement requires companies to expense research and development costs encompassed by the Statement in the period they are incurred. Companies that had deferred research and development costs were required to restate their financial statements by prior period adjustment in the period in which FASB Statement No. 2 [AC section R50] became effective. Deferring research and development costs before FASB Statement No. 2 [AC section R50] became effective was an acceptable alternative principle under GAAP, although FASB Statement No. 2 [AC section R50] proscribed such treatment for fiscal years beginning on or after January 1, 1975. Where the accounting principles being followed are currently acceptable, the auditor

<sup>[1]</sup> [Footnote deleted.]

<sup>2</sup> Originally issued under the title "Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs" (*Journal of Accountancy*, Jan. '75, p. 74).

\* This paragraph is based on the concepts in Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*. SAS No. 5 was superseded by SAS No. 69 (with the same title), effective for audits of financial statements for periods ending after March 15, 1992. This Interpretation has not been revised to reflect the changes necessary due to the issuance of SAS No. 69.

should not qualify his opinion if a company does not adopt before an FASB Statement becomes effective accounting principles that will be prescribed by that Statement. Other reporting considerations are addressed in the following paragraphs.

.16 Section 508, *Reports on Audited Financial Statements*, Paragraph .55 states: "Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include related notes)." Similarly, APB Statement No. 4, paragraph 106 on adequate disclosure states: "The headings, captions and amounts must be supplemented by enough additional data so that their meaning is clear. . . ." For financial statements that are prepared on the basis of accounting principles that are acceptable at the financial-statement date but that will not be acceptable in the future, the auditor should consider whether disclosure of the impending change in principle and the resulting restatement are essential data. If he decides that the matter should be disclosed and it is not, the auditor should express a qualified or adverse opinion as to conformity with GAAP, as required by section 508.55.

.17 To evaluate the adequacy of disclosure of the prospective change in principle, the auditor should assess the potential effect on the financial statements. Using the research and development cost example given above, the effect of the anticipated prior period adjustment to write off previously deferred research and development costs would in some instances be so material that disclosure would be essential for an understanding of the financial statements. In cases such as this, where the estimated impact is so material, disclosure can best be made by supplementing the historical financial statements with pro forma financial data that give effect to the future adjustment as if it had occurred on the date of the balance sheet. (See section 560.05.) The pro forma data may be presented in columnar form alongside the historical statements, in the notes to the historical statements, or in separate pro forma statements presented with the historical statements.

.18 Even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, he decides not to qualify his opinion, he nevertheless may decide to include an explanatory paragraph in his report if the effects of the change are expected to be unusually material. The explanatory paragraph should not be construed as a qualification of the auditor's opinion; it is intended to highlight circumstances of particular importance and to aid in interpreting the financial statements (see section 508.37).

.19 The auditor should also consider the effect of an uncertainty that may result upon a required future adoption of an accounting principle. For example, such an uncertainty may arise where the future adoption of such a principle will result in a reduction to stockholders' equity that may cause the company to be in violation of its debt covenants, which in turn may accelerate the due date for repayment of debt. In such case, the auditor should consider the effect on his report of the uncertainty and if he concludes a material uncertainty exists, add an explanatory paragraph (following the opinion paragraph) to his report as discussed in section 508.27—33.

[Issue Date: October, 1979.]

**AU Section 411*****The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report***

(Supersedes SAS No. 5)

Source: SAS No. 69.

Effective for audits of financial statements for periods ending after March 15, 1992.

.01 An independent auditor's unqualified opinion usually reads as follows:

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

The purpose of this section is to explain the meaning of the phrase "present fairly . . . in conformity with generally accepted accounting principles" in the independent auditor's report.

.02 The first standard of reporting requires an auditor who has audited financial statements in accordance with generally accepted auditing standards to state in the auditor's report whether the statements are presented in accordance with generally accepted accounting principles. The phrase "generally accepted accounting principles" is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures (see paragraph 138 of Statement No. 4 of the Accounting Principles Board). Those conventions, rules, and procedures provide a standard by which to measure financial presentations.

.03 The independent auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles. Without that framework, the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and cash flows in financial statements.

.04 The auditor's opinion that financial statements present fairly an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles should be based on his or her judgment as to whether (a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation (see section 431); (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, it is



neither too detailed nor too condensed (see section 431); and (e ) the financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.<sup>1</sup>

.05 Independent auditors agree on the existence of a body of generally accepted accounting principles, and they are knowledgeable about these principles and in the determination of their general acceptance. Nevertheless, the determination that a particular accounting principle is generally accepted may be difficult because no single reference source exists for all such principles. The sources of established accounting principles that are generally accepted in the United States are—

- a. Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to rule 203 [ET section 203.01] of the AICPA Code of Professional Conduct. Rule 203 [ET section 203.01] provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 [ET section 203.01] implies that application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles. Nevertheless, rule 203 [ET section 203.01] provides for the possibility that literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. (See section 508, *Reports on Audited Financial Statements*, paragraphs .14 and .15.)
- b. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in category (a ).<sup>2</sup>
- c. Pronouncements of bodies, organized by a body referred to in category (a ) and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in category (b ) that have been cleared by a body referred to in category (a ) but have not been exposed for public comment.
- d. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally accepted.

.06 Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance. The

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<sup>1</sup> The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (see sections 150.04, 312.06, and 508.50).

<sup>2</sup> For purposes of this section, the word *cleared* means that a body referred to in subparagraphs (a ) has indicated that it does not object to the issuance of the proposed pronouncement.

auditor should consider whether the substance of transactions or events differs materially from their form.

.07 If the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 [ET section 203.01], the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. If an established accounting principle from one or more sources in category (b), (c), or (d) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (b), (c), or (d), the auditor should follow the treatment specified by the source in the higher category—for example, follow category (b) treatment over category (c)—or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstances.

.08 The auditor should be aware that the accounting requirements adopted by regulatory agencies for reports filed with them may differ from generally accepted accounting principles in certain respects. Section 544, *Lack of Conformity With Generally Accepted Accounting Principles*, paragraph .04 and section 623, *Special Reports* provide guidance if the auditor is reporting on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.

.09 Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting an accounting principle that appears appropriate when applied in a manner similar to the application of an established principle to an analogous transaction or event.

## Application to Nongovernmental Entities

.10 For financial statements of entities other than governmental entities—<sup>3</sup>

- a. Category (a), officially established accounting principles, consists of Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board (APB) Opinions, and AICPA Accounting Research Bulletins.
- b. Category (b) consists of FASB Technical Bulletins and, if cleared <sup>4</sup> by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.
- c. Category (c) consists of AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins that have been cleared <sup>4</sup> by

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<sup>3</sup> Rules and interpretive releases of the Securities and Exchange Commission (SEC) have an authority similar to category (a) pronouncements for SEC registrants. In addition, the SEC staff issues Staff Accounting Bulletins that represent practices followed by the staff in administering SEC disclosure requirements. Also, the Introduction to the FASB's *EITF Abstracts* states that the Securities and Exchange Commission's Chief Accountant has said that the SEC staff would challenge any accounting that differs from a consensus of the FASB Emerging Issues Task Force, because the consensus position represents the best thinking on areas for which there are no specific standards.

<sup>4</sup> The auditor should assume that such pronouncements have been cleared by the FASB unless the pronouncement indicates otherwise.

the FASB and consensus positions of the FASB Emerging Issues Task Force.

- d. Category (d) includes AICPA accounting interpretations and implementation guides (“Qs and As”) published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

.11 In the absence of a pronouncement covered by rule 203 [ET section 203.01] or another source of established accounting principles, the auditor of financial statements of entities other than governmental entities may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, FASB Statements of Financial Accounting Concepts; APB Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; Governmental Accounting Standards Board (GASB) Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, FASB Statements of Financial Accounting Concepts would normally be more influential than other sources in this category.

## Application to State and Local Governmental Entities

.12 For financial statements of state and local governmental entities—<sup>5</sup>

- a. Category (a), officially established accounting principles, consists of GASB Statements and Interpretations, as well as AICPA and FASB pronouncements specifically made applicable to state and local governmental entities by GASB Statements or Interpretations. GASB Statements and Interpretations are periodically incorporated in the *Codification of Governmental Accounting and Financial Reporting Standards*.
- b. Category (b) consists of GASB Technical Bulletins and, if specifically made applicable to state and local governmental entities by the AICPA and cleared <sup>6</sup> by the GASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.
- c. Category (c) consists of AICPA AcSEC Practice Bulletins if specifically made applicable to state and local governmental entities and cleared <sup>6</sup> by the GASB, as well as consensus positions of a group of accountants organized by the GASB that attempts to reach consensus positions on accounting issues applicable to state and local governmental entities.<sup>7</sup>
- d. Category (d) includes implementation guides (“Qs and As”) published by the GASB staff, as well as practices that are widely recognized and prevalent in state and local government.

<sup>5</sup> State and local governmental entities include public benefit corporations and authorities; public employee retirement systems; and governmental utilities, hospitals and other health care providers, and colleges and universities.

<sup>6</sup> The auditor should assume that such pronouncements specifically made applicable to state and local governments have been cleared by the GASB unless the pronouncement indicates otherwise.

<sup>7</sup> As of the date of this section, the GASB had not organized such a group.

.13 In the absence of a pronouncement covered by rule 203 [ET section 203.01] or another source of established accounting principles, the auditor of financial statements of state and local governmental entities may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, GASB Concepts Statements; the pronouncements referred to in categories (a) through (d) of paragraph .10 when not specifically made applicable to state and local governmental entities either by the GASB or by the organization issuing them; APB Statements; FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, GASB Concepts Statements would normally be more influential than other sources in this category.

## Effective Date

.14 This section is effective for audits of financial statements for periods ending after March 15, 1992.

## Transition

.15 Most of the pronouncements or practices in categories (b), (c), and (d) of paragraphs .10 and .12 had equal authoritative standing prior to the issuance of this section. An entity following an accounting treatment in category (c) or (d) as of March 15, 1992, need not change to an accounting treatment in a category (b) or category (c) pronouncement whose effective date is before March 15, 1992. For example, a nongovernmental entity that followed a prevalent industry practice (category (d)) as of March 15, 1992, need not change to an accounting treatment included in a pronouncement in category (b) or (c) (for example, an accounting principle in a cleared AICPA Statement of Position or AcSEC Practice Bulletin) whose effective date is before March 15, 1992. For pronouncements whose effective date is subsequent to March 15, 1992, and for entities initially applying an accounting principle after March 15, 1992 (except for FASB Emerging Issues Task Force consensus positions issued before March 16, 1992, which become effective in the hierarchy for initial application of an accounting principle after March 15, 1993), the auditor should follow the applicable hierarchy established by paragraphs .10 and .12 in determining whether an entity's financial statements are fairly presented in conformity with generally accepted accounting principles.

**.16 GAAP Hierarchy Summary \***

	<i>Nongovernmental Entities</i>	<i>State and Local Governments</i>
<i>Established Accounting Principles</i>	.10a FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins	.12a GASB Statements and Interpretations, plus AICPA and FASB pronouncements if made applicable to state and local governments by a GASB Statement or Interpretation
	.10b FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position	.12b GASB Technical Bulletins, and the following pronouncements if specifically made applicable to state and local governments by the AICPA: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position
	.10c Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins	.12c Consensus positions of the GASB Emerging Issues Task Force ‡ and AICPA Practice Bulletins if specifically made applicable to state and local governments by the AICPA
	.10d AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent	.12d "Qs and As" published by the GASB staff, as well as industry practices widely recognized and prevalent
<i>Other Accounting Literature †</i>	.11 Other accounting literature, including FASB Concepts Statements; APB Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA <i>Technical Practice Aids</i> ; and accounting textbooks, handbooks, and articles	.13 Other accounting literature, including GASB Concepts Statements; pronouncements in categories (a) through (d) of the hierarchy for nongovernmental entities when not specifically made applicable to state and local governments; APB Statements; FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; pronouncements of other professional associations or regulatory agencies; AICPA <i>Technical Practice Aids</i> ; and accounting textbooks, handbooks, and articles

\* Paragraph references correspond to the paragraphs of this section that describe the categories of the GAAP hierarchy.

† In the absence of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.

‡ As of the date of this section, the GASB had not organized such a group.

**AU Section 420*****Consistency of Application of Generally Accepted Accounting Principles***

Sources: SAS No. 1, section 420; SAS No. 43.

See section 9420 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The second standard of reporting (referred to herein as the consistency standard) is:

The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

.02 The objective of the consistency standard is to ensure that if comparability of financial statements between periods has been materially affected by changes in accounting principles, there will be appropriate reporting by the independent auditor regarding such changes.<sup>1</sup> It is also implicit in the objective that such principles have been consistently observed within each period. The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods because either (a) no change in accounting principles has occurred, or (b) there has been a change in accounting principles or in the method of their application, but the effect of the change on the comparability of the financial statements is not material. In these cases, the auditor would not refer to consistency in his report.

.03 Proper application of the consistency standard by the independent auditor requires an understanding of the relationship of consistency to comparability. Although lack of consistency may cause lack of comparability, other factors unrelated to consistency may also cause lack of comparability.<sup>2</sup>

.04 A comparison of the financial statements of an entity between years may be affected by (a) accounting changes, (b) an error in previously issued financial statements, (c) changes in classification, and (d) events or transactions substantially different from those accounted for in previously issued statements. Accounting change, as defined in APB Opinion No. 20 [AC section A06], means a change in (1) an accounting principle, (2) an accounting estimate, or (3) the reporting entity (which is a special type of change in accounting principle).

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<sup>1</sup> The appropriate form of reporting on a lack of consistency is discussed in section 508.34—.36. [Footnote added to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>2</sup> For a discussion of comparability of financial statements of a single enterprise, see paragraphs 95 through 97 of Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises". [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

.05 Changes in accounting principle having a material effect on the financial statements require recognition in the independent auditor's report through the addition of an explanatory paragraph (following the opinion paragraph). Other factors affecting comparability in financial statements may require disclosure, but they would not ordinarily be commented upon in the independent auditor's report.

## Accounting Changes Affecting Consistency

### Change in Accounting Principle

.06 "A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes not only accounting principles and practices but also the methods of applying them."<sup>3</sup> A change in accounting principle includes, for example, a change from the straight-line method to the declining balance method of depreciation for all assets in a class or for all newly acquired assets in a class. The consistency standard is applicable to this type of change and requires recognition in the auditor's report through the addition of an explanatory paragraph. [As modified, effective January 1, 1975, by FASB Statement No. 2 (AC section R50).]

### Change in the Reporting Entity

.07 Since a change in the reporting entity is a special type of change in accounting principle, the consistency standard is applicable. Changes in reporting entity that require recognition in the auditor's report include:

- a. Presenting consolidated or combined statements in place of statements of individual companies.
- b. Changing specific subsidiaries comprising the group of companies for which consolidated statements are presented.
- c. Changing the companies included in combined financial statements.
- d. Changing among the cost, equity, and consolidation methods of accounting for subsidiaries or other investments in common stock.

### Reports Following a Pooling of Interests

.08 When companies have merged or combined in accordance with the accounting concept known as a "pooling of interests," appropriate effect of the pooling should be given in the presentation of financial position, results of operations, cash flows, and other historical financial data of the continuing business for the year in which the combination is consummated and, in comparative financial statements, for years prior to the year of pooling, as described in APB Opinion No. 16, *Business Combinations* [AC section B50]. If prior year financial statements, presented in comparison with current year financial statements, are not restated to give appropriate recognition to a pooling of interests, the comparative financial statements are not presented on a consistent basis. In this case, the inconsistency arises not from a change in the application of an accounting principle in the current year, but from the lack of such application to prior years. Such inconsistency would require the

<sup>3</sup> Accounting Principles Board Opinion No. 20, paragraph 7 [AC section A06.105]. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

auditor to add an explanatory paragraph to the report. In addition, failure to give appropriate recognition to the pooling in comparative financial statements is a departure from generally accepted accounting principles. [Paragraph added to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

**.09** When single-year statements only are presented for the year in which a combination is consummated, a note to the financial statements should adequately disclose the pooling transaction and state the revenues, extraordinary items, and net income of the constituent companies for the preceding year on a combined basis. In such instances, the disclosure and consistency standards are met. Omission of disclosure of the pooling transaction and its effect on the preceding year would require the auditor to qualify the opinion because of the lack of disclosure and may also require the auditor to add an explanatory paragraph to the report because of the inconsistency (See footnote 20 of section 508.61). [Paragraph added to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

**.10** For purposes of application of the consistency standard, a change in reporting entity does not result from the creation, cessation, purchase, or disposition of a subsidiary or other business unit. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### Correction of an Error in Principle

**.11** A change from an accounting principle that is not generally accepted to one that is generally accepted, including correction of a mistake in the application of a principle, is a correction of an error. Although this type of change in accounting principle should be accounted for as the correction of an error,<sup>4</sup> the change requires recognition in the auditor's report through the addition of an explanatory paragraph. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]<sup>[5]</sup>

### Change in Principle Inseparable From

#### Change in Estimate

**.12** The effect of a change in accounting principle may be inseparable from the effect of a change in estimate.<sup>6</sup> Although the accounting for such a change is the same as that accorded a change only in estimate, a change in principle is involved. Accordingly, this type of change requires recognition in the independent auditor's report through the addition of an explanatory paragraph. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

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<sup>4</sup> See paragraphs 13, 36, and 37 of Accounting Principles Board Opinion No. 20 [AC section A35.104—.105]. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>[5]</sup> Footnote deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

<sup>6</sup> See paragraph 11 of Accounting Principles Board Opinion No. 20 [AC section A06.110]. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]



### Changes in Presentation of Cash Flows

.13 For purposes of presenting cash flows, FASB Statement No. 95, *Statement of Cash Flows* [AC section C25], states that, "An enterprise shall disclose its policy for determining which items are treated as cash equivalents. Any change to that policy is a change in accounting principle that shall be effected by restating financial statements for earlier years presented for comparative purposes." Accordingly, this type of change in presentation of cash flows requires recognition in the independent auditor's report through the addition of an explanatory paragraph. [Paragraph added to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

## Changes Not Affecting Consistency

### Change in Accounting Estimate

.14 Accounting estimates (such as service lives and salvage values of depreciable assets and provisions for warranty costs, uncollectible receivables, and inventory obsolescence) are necessary in the preparation of financial statements. Accounting estimates change as new events occur and as additional experience and information are acquired. This type of accounting change is required by altered conditions that affect comparability but do not involve the consistency standard. The independent auditor, in addition to satisfying himself with respect to the conditions giving rise to the change in accounting estimate, should satisfy himself that the change does not include the effect of a change in accounting principle. Provided he is so satisfied, he need not comment on the change in his report.<sup>[7]</sup> However, an accounting change of this type having a material effect on the financial statements may require disclosure in a note to the financial statements.<sup>8</sup> [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### Error Correction Not Involving Principle

.15 Correction of an error in previously issued financial statements resulting from mathematical mistakes, oversight, or misuse of facts that existed at the time the financial statements were originally prepared does not involve the consistency standard if no element of accounting principles or their application is included. Accordingly, the independent auditor need not recognize the correction in his report.<sup>9</sup> [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### Changes in Classification and Reclassifications

.16 Classifications in the current financial statements may be different from classifications in the prior year's financial statements. Although changes in classification are usually not of sufficient importance to necessitate disclo-

<sup>[7]</sup> Footnote deleted. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>8</sup> See paragraph 33 of Accounting Principles Board Opinion No. 20 [AC section A06.132]. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>9</sup> If the independent auditor had previously reported on the financial statements containing the error, he should refer to section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

sure, material changes in classification should be indicated and explained in the financial statements or notes. These changes and material reclassifications made in previously issued financial statements to enhance comparability with current financial statements ordinarily would not need to be referred to in the independent auditor's report. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### **Variations in Presentation of Statement of Changes in Financial Position**

.17 [Paragraph renumbered and deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### **Substantially Different Transactions or Events**

.18 Accounting principles are adopted when events or transactions first become material in their effect. Such adoption, as well as modification or adoption of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring, do not involve the consistency standard although disclosure in the notes to the financial statements may be required. [Formerly paragraph .17, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### **Changes Expected to Have a Material Future Effect**

.19 If an accounting change has no material effect on the financial statements in the current year, but the change is reasonably certain to have substantial effect in later years, the change should be disclosed in the notes to the financial statements whenever the statements of the period of change are presented, but the independent auditor need not recognize the change in his report. [Formerly paragraph .18, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### **Disclosure of Changes Not Affecting Consistency**

.20 While the matters do not require the addition of an explanatory paragraph about consistency in the independent auditor's report, the auditor should qualify his opinion as to the disclosure matter if necessary disclosures are not made. (See section 431.) [Reference changed by issuance of Statement on Auditing Standards No. 32. Formerly paragraph .19, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### **Periods to Which the Consistency Standard Relates**

.21 When the independent auditor reports only on the current period, he should obtain sufficient, competent evidential matter about consistency of the application of accounting principles, regardless of whether financial state-

ments for the preceding period are presented. (The term "current period" means the most recent year, or period of less than one year, upon which the independent auditor is reporting.) When the independent auditor reports on two or more years, he should address the consistency of the application of accounting principles between such years and the consistency of such years with the year prior thereto if such prior year is presented with the financial statements being reported upon. [Formerly paragraph .20, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Paragraph renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### **Consistency Expression**

[.22] [Paragraph renumbered and deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### **First Year Audits**

.23 When the independent auditor has not audited the financial statements of a company for the preceding year, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent between the current and the preceding year. Where adequate records have been maintained by the client, it is usually practicable and reasonable to extend auditing procedures to gather sufficient competent evidential matter about consistency.

.24 Inadequate financial records or limitations imposed by the client may preclude the independent auditor from obtaining sufficient, competent evidential matter about the consistent application of accounting principles between the current and the prior year, as well as to the amounts of assets or liabilities at the beginning of the current year. Where such amounts could materially affect current operating results, the independent auditor would also be unable to express an opinion on the current year's results of operations and cash flows.

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[The next page is 501.]

**AU Section 9420*****Consistency of Application of Generally Accepted Accounting Principles: Auditing Interpretations of Section 420*****[1.] The Effect of APB Opinion No. 30 on Consistency<sup>1</sup>**

[.01—.10] [Superseded October, 1979 by Interpretation No. 5, paragraphs .28—.31.]

**2. The Effect of APB Opinion No. 28 on Consistency**

.11 *Question*—Independent auditors may be engaged to report on financial information for an annual period and a subsequent interim period. Should the auditor add an explanatory paragraph (following the opinion paragraph) to his report in those circumstances where accounting principles and practices used in preparing the annual financial information have been modified in accordance with APB Opinion No. 28 [AC section I73] in preparing the interim financial statements?

.12 *Interpretation*—No. The auditor should not add an explanatory paragraph to his report because of these modifications. Although the modifications deemed appropriate under Opinion No. 28 [AC section I73] may appear to be changes in the methods of applying accounting principles, they differ from changes in methods that require an explanatory paragraph since the modifications are made in order to recognize a difference in circumstances, that is, a difference between presenting financial information for a year and presenting financial information for only a part of a year.

.13 Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph .02, states: "The objective of the consistency standard is to ensure that if comparability of financial statements between periods has been materially affected by changes in accounting principles there will be appropriate reporting by the independent auditor regarding such changes." Section 420.02 refers to changes in methods that lessen the usefulness of financial statements in comparing the financial information of one period with that of an earlier period. Thus, the purpose of an explanatory paragraph about consistency in the auditor's report is to alert readers of the report not to make an unqualified comparison of the financial information for the two periods.

.14 The modifications introduced by Opinion No. 28 [AC section I73], however, do not lessen the comparability of the financial information of an interim period with that of a preceding annual period. On the contrary, those modifications are intended to enhance comparability between the two sets of financial information. As paragraph 10 of Opinion No. 28 [AC section I73.103] states, the modifications are needed "so that the reported results for the interim period may better relate to the results of operations for the annual period."

.15 Thus the modifications introduced by Opinion No. 28 [AC section I73] are not of the type that would require an explanatory paragraph (following the opinion paragraph) in the auditor's report. Independent auditors

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<sup>1</sup>Originally issued under the title "Reporting on Consistency and Extraordinary Items" (*Journal of Accountancy*, Jan. '74, p. 67).

should, of course, add an explanatory paragraph if changes of the type that lessen comparability are introduced in the interim financial information.

[Issue Date: February, 1974.]

### **3. Impact on the Auditor's Report of FIFO to LIFO Change in Comparative Financial Statements**

**.16 Question**—Changing economic conditions have caused some companies to change their inventory pricing methods from the first in, first out (FIFO) method to the last in, first out (LIFO) method. When a company presents comparative financial statements and the year of the FIFO to LIFO change is the earliest year both presented and reported on, should the auditor refer to that change in accounting principle in his report?

**.17 Interpretation**—The auditor would not be required to refer in his report to a FIFO to LIFO change in the circumstances described above.

**.18** A change in accounting principle usually results in including the cumulative effect of the change in net income of the period of the change. A change in inventory pricing method from FIFO to LIFO, however, is a change in accounting principle that ordinarily does not affect retained earnings at the beginning of the period in which the change was made. (See APB Opinion No. 20, paragraphs 14(d) and 26.)<sup>2</sup>

**.19** An example of typical disclosure of a FIFO to LIFO change in the year of the change is as follows:

"In 1974, the company adopted the last in, first out (LIFO) method of costing inventory. Previously, the first in, first out (FIFO) method of costing inventory was used. Management believes that the LIFO method has the effect of minimizing the impact of price level changes on inventory valuations and generally matches current costs against current revenues in the income statement. The effect of the change was to reduce net income by \$xxxx (\$xx per share) from that which would otherwise have been reported. There is no cumulative effect on prior years since the ending inventory as previously reported (1973) is the beginning inventory for LIFO purposes. Accordingly, pro forma results of operations for the prior year had LIFO been followed is not determinable."

**.20** Section 420, *Consistency of Application of Generally Accepted Accounting Principles*. Paragraph .19 discusses the periods to which the consistency standard relates: "When the independent auditor reports on two or more years, he should address the consistency of the application of accounting principles between such years. . . ." For a FIFO to LIFO change made in the earliest year presented and reported on, there is no inconsistency in the application of accounting principles, and comparability between the earliest year and subsequent years is not affected since no cumulative effect is reported in the year of the change. Consequently, the independent auditor need not refer to the change in inventory pricing methods.

**[.21—.23]** [Paragraphs deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

[Interpretation amended to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

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<sup>2</sup> AC section A06.122.

[Issue Date: January, 1975.]

**[4.] The Effect of FASB Statement No. 13 on Consistency<sup>[3]</sup>**

[.24—.27] [Withdrawn March, 1989 by the Auditing Standards Board.]

**5. The Effects of Changes in Accounting Principles and Classification on Consistency**

**.28 Question**—In what circumstances, if any, should an auditor add an explanatory paragraph (following the opinion paragraph) to his report because of a change in financial statement classification?

**.29 Interpretation**—Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph .16, states: "Classifications in the current financial statements may be different from classifications in the prior year's financial statements. . . . These changes . . . ordinarily would not need to be referred to in the independent auditor report." An example of the type of change contemplated by section 420.16, is combining "Cash on hand" with "Cash in bank" to create a new classification, "Cash."

**.30** However, section 420.16, does not contemplate a change in classification that affects significantly the *measurement* of financial position or results of operations. Such a change would call for the addition of an explanatory paragraph (following the opinion paragraph) in the auditor's report. For example, APB Opinion No. 30 [AC sections I13 and I17], changed significantly the types of items that are to be reported as extraordinary, and this in turn changed the measurement of "income before extraordinary items" and the related per share amounts. Many accountants believe that the amount of income before extraordinary items is a very important aspect of an income statement. As evidence of its importance, APB Opinion No. 15 [AC section E09], requires that earnings per share be presented for income before extraordinary items. By changing the determination of income before extraordinary items, Opinion No. 30 [AC sections I13 and I17], changed the *measurement* of results of operations.

**.31** Such a change would call for the addition of an explanatory paragraph (following the opinion paragraph) in the auditor's report whether or not the change was elective or mandatory. In either case, if the change in principle has a material effect on comparability, the auditor should comment on the change in his report (as discussed in section 508.34—.36) unless the financial statements for the prior year have been restated to apply the change retroactively.

[Issue Date: October, 1979.]

**[6.] The Effect of FASB Statement No. 34 on Consistency**

[.32—.43] [Withdrawn March, 1989 by the Auditing Standards Board.]

**[7.] The Effect of FASB Statement No. 31 on Consistency**

[.44—.51] [Withdrawn March, 1989 by the Auditing Standards Board.]

**8. The Effect of Accounting Changes by an Investee on Consistency**

**.52 Question**—Does a change in accounting principle by an investee accounted for by the equity method require the auditor to add an explanatory

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<sup>[3]</sup> [Footnote deleted.]

paragraph (following the opinion paragraph) to his report on the financial statements of the investor?

**.53 Interpretation**—Changes in accounting principle affect the comparability of financial statements regardless of whether such changes originate at the investor level or are made solely by an investee.<sup>4</sup> Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph .02, states: “The objective of the consistency standard is to ensure that if comparability of financial statements between periods has been materially affected by changes in accounting principles there will be appropriate reporting by the independent auditor regarding such changes.”

**.54** Thus, the auditor would need to add an explanatory paragraph (following the opinion paragraph) to his report when there has been a change in accounting principle by an investee accounted for by the equity method that causes a material lack of comparability in the financial statements of an investor.

[.55—.57] [Paragraphs deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

[Issue Date: July, 1980.]

## **[9.] The Effect of Adoption of FASB Statement No. 35 on Consistency**

[.58—.63] [Withdrawn March, 1989 by the Auditing Standards Board.]

## **10. Change in Presentation of Accumulated Benefit Information in the Financial Statements of a Defined Benefit Pension Plan**

**.64 Question**—FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans* [AC section Pe5] requires the presentation of information regarding the actuarial present value of accumulated plan benefits and year-to-year changes therein of a defined benefit pension plan but permits certain flexibility in presenting such information. The information may be included on the face of a financial statement (a separate statement or one that combines accumulated benefit information with asset information), or it may be included in the notes to the financial statements. Furthermore, the benefit information may be as of the beginning of the period being reported upon or as of the end of that period. Does a change in the format of presentation of accumulated benefit information or a change in the date as of which such information is presented require the auditor to add an explanatory paragraph (after the opinion paragraph) to his report because of the change?

**.65 Interpretation**—Such changes in the presentation of information regarding accumulated benefits are considered reclassifications or variations in the nature of information presented. Changes such as these that are material should be explained in the financial statements or notes, but these changes ordinarily would not require the auditor to add this explanatory paragraph to his report (see section 420.14).

[Issue Date: December, 1980.]

## **11. The Effect of the Adoption of FASB Statement No. 36 on Consistency**

[.66—.68] [Withdrawn March, 1989 by the Auditing Standards Board.]

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[The next page is 521.]

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<sup>4</sup> For a discussion of comparability of financial statements of a single enterprise, see paragraphs 95 through 97 of Accounting Principles Board Statement No. 4, “Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises.”

**AU Section 431*****Adequacy of Disclosure  
in Financial Statements***

(Supersedes Statement on Auditing Standards No. 1,  
section 430)

**Source:** SAS No. 32.

**Issue date, unless otherwise indicated:** October, 1980.

.01 The third standard of reporting is:

Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

.02 The presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. An independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time.

.03 If management omits from the financial statements, including the accompanying notes, information that is required by generally accepted accounting principles, the auditor should express a qualified or an adverse opinion and should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards.<sup>1</sup> In this context, *practicable* means that the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information. For example, the auditor would not be expected to prepare a basic financial statement or segment information and include it in his report when management omits such information.

.04 In considering the adequacy of disclosure, and in other aspects of his audit, the auditor uses information received in confidence from the client. Without such confidence, the auditor would find it difficult to obtain information necessary for him to form an opinion on financial statements. Thus, the auditor should not ordinarily make available, without the client's consent, information that is not required to be disclosed in financial statements to comply with generally accepted accounting principles (see AICPA Code of Professional Conduct, Rule 301 [ET section 301.01]).

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[The next page is 541.]

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<sup>1</sup> An independent auditor may participate in preparing financial statements, including accompanying notes. The financial statements, including accompanying notes, however, remain the representations of management, and such participation by the auditor does not require him to modify his report (see section 110.02).



## AU Section 435

### **Segment Information**<sup>\*1</sup>

Source: SAS No. 21.

Issue date, unless otherwise indicated: December, 1977.

.01 Statement of Financial Accounting Standards No. 14 [AC section S20], *Financial Reporting for Segments of a Business Enterprise*, requires the inclusion of certain information about an entity's operations in different industries, its foreign operations and export sales, and its major customers (referred to in this section as "segment information") in annual financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Disclosure of segment information requires the disaggregation of certain significant elements of an entity's financial statements, such as revenue, operating profit or loss, identifiable assets, depreciation, and capital expenditures. This section provides guidance to an auditor in auditing and reporting on financial statements that are required to include segment information in conformity with FASB Statement No. 14 [AC section S20].

.02 Segment information is one of the disclosures required by generally accepted accounting principles as an integral part of financial statements. The purpose of segment information is stated in paragraph 5 of FASB Statement No. 14 [AC section S20.106]:

The purpose of the information required to be reported by this Statement is to assist financial statement users in analyzing and understanding the enterprise's financial statements by permitting better assessment of the enterprise's past performance and future prospects . . . . information prepared in conformity with this Statement may be of limited usefulness for comparing a segment of one enterprise with a similar segment of another enterprise.

### **Auditor's Objective**

.03 The objective of auditing procedures applied to segment information is to provide the auditor with a reasonable basis for concluding whether the information is presented in conformity with FASB Statement No. 14 [AC section S20] in relation to the financial statements taken as a whole. The auditor performing an audit of financial statements in accordance with generally accepted auditing standards considers segment information, as other informative disclosures, in relation to the financial statements taken as a whole, and is not required to apply auditing procedures that would be necessary to express a separate opinion on the segment information.

### **Auditing Procedures**

.04 Paragraphs .05—.07 of this section provide guidance as to auditing procedures when financial statements include segment information. If an

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\* See FASB Statement No. 21 [AC section S20.101—.103 and S20.407], *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*.

<sup>1</sup> The meaning of the term "segment information" in this section differs from that of the term "segment" in section 623, *Special Reports*, paragraph .02.

entity represents to the auditor that it does not have industry segments, foreign operations, export sales, or major customers required to be disclosed by FASB Statement No. 14 [AC section S20], the auditor should follow the guidance in paragraph .15 of this section.

**.05** The auditor applies the concept of materiality, discussed in section 150.04, in determining the nature, timing, and extent of auditing procedures to be applied in an audit of financial statements. Materiality of segment information is evaluated primarily by relating the dollar magnitude of the information to the financial statements taken as a whole. However, as with other elements of financial statements, the materiality of segment information does not depend entirely on relative size; the concept involves qualitative as well as quantitative judgments. (A discussion of materiality as it relates to the auditor's report is included in paragraph .08 of this section.)

**.06** In planning his audit, it may be necessary for the auditor to modify or redirect selected audit tests to be applied to the financial statements taken as a whole. For example, the auditor may decide to select inventories for physical observation on the basis of industry segments or geographic areas. Factors such as the following should be considered by the auditor in determining whether his procedures should be modified or redirected:

- a. Internal control structure and the degree of integration, centralization, and uniformity of the accounting records.
- b. The nature, number, and relative size of industry segments and geographic areas.
- c. The nature and number of subsidiaries or divisions in each industry segment and geographic area.
- d. The accounting principles used for the industry segments and geographic areas.

In any event, the tests of underlying accounting records normally applied in an audit of financial statements should include a consideration of whether the entity's revenue, operating expenses, and identifiable assets are appropriately classified among industry segments and geographic areas.

**.07** In addition, the auditor should apply the following procedures to segment information presented in financial statements:

- a. Inquire of management concerning its methods of determining segment information, and evaluate the reasonableness of those methods in relation to the factors identified in FASB Statement No. 14 [AC section S20] for making those determinations.<sup>2</sup>
- b. Inquire as to the bases of accounting for sales or transfers between industry segments and between geographic areas, and test, to the extent considered necessary, those sales or transfers for conformity with the bases of accounting disclosed.
- c. Test the disaggregation of the entity's financial statements into segment information. The tests should include (1) an evaluation of the entity's application of the various percentage tests specified in paragraphs 15—20 and 31—39 of FASB Statement No. 14 [AC

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<sup>2</sup> Paragraphs 11—21 and Appendix D of FASB Statement No. 14 [AC sections S20.113—.127 and S20.409] discuss how an entity's industry segments and reportable segments should be determined. Paragraph 34 of that Statement [AC section S20.140] describes factors to be considered in grouping the countries in which an entity operates into geographic areas, and paragraphs 36 and 39 [AC section S20.142] describe criteria for disclosing export sales and major customers, respectively.

sections S20.119—.126 and S20.137—.144], and (2) application of analytical procedures to the segment information to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual. Analytical procedures, for purposes of this section, consist of (a) comparison of the segment information with comparable information for the immediately preceding year, (b) comparison of the segment information with any available related budgeted information for the current year, and (c) study of the relationships of elements of the segment information that would be expected to conform to a predictable pattern based on the entity's experience (for example, operating profit as a percentage of both total revenue and identifiable assets by industry segment or geographic area). In applying these procedures, the auditor should consider the types of matters that in the preceding year have required accounting adjustments of segment information. [As modified, November 1979, by the Auditing Standards Board.]

- d. Inquire as to the methods of allocating operating expenses incurred and identifiable assets used jointly by two or more segments, evaluate whether those methods are reasonable, and test the allocations to the extent considered necessary.
- e. Determine whether the segment information has been presented consistently from period to period and, if not, whether the nature and effect of the inconsistency are disclosed and, if applicable, whether the information has been retroactively restated in conformity with paragraph 40 of FASB Statement No. 14 [AC section S20.146].

## Reporting

.08 The auditor's standard report on financial statements prepared in conformity with generally accepted accounting principles implicitly applies to segment information included in those statements in the same manner that it applies to other informative disclosures in the financial statements that are not clearly marked as "unaudited."<sup>3</sup> The auditor's standard report would not refer to segment information unless his audit revealed a misstatement or omission, or a change in accounting principle, relating to the segment information that is material in relation to the financial statements taken as a whole, or the auditor was unable to apply the auditing procedures that he considered necessary in the circumstances. The auditor should consider qualitative as well as quantitative factors in evaluating whether such a matter is material to the financial statements taken as a whole. The significance of a matter to a particular entity (for example, a misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity), the pervasiveness of a matter (for example, whether it affects the amounts and presentation of numerous items in the segment information), and the impact of a matter (for

<sup>3</sup> If an entity discloses comparative segment information for fiscal years beginning prior to December 15, 1976, that information should be clearly marked as "unaudited" unless the auditor has applied to that segment information the auditing procedures set forth in this section. If the auditor concludes, on the basis of facts known to him, that segment information marked "unaudited" is not in conformity with FASB Statement No. 14 [AC section S20] in relation to the financial statements taken as a whole, he should follow the guidance in section 504. [Reference changed by the issuance of Statement on Auditing Standards No. 26, *Association with Financial Statements*.]

example, whether it distorts the trends reflected in the segment information) should all be considered in judging whether a matter relating to segment information is material to the financial statements taken as a whole. Accordingly, situations may arise in practice where the auditor will conclude that a matter relating to segment information is material to the financial statements taken as a whole even though, in his judgment, it is quantitatively immaterial to those financial statements.

### **Misstatement or Omission of Segment Information**

.09 If the audit reveals a misstatement in the segment information that is material in relation to the financial statements taken as a whole and that misstatement is not corrected, the auditor should modify<sup>4</sup> his opinion on the financial statements because of a departure from generally accepted accounting principles. The following is an example of an auditor's report qualified because of a misstatement of segment information.

#### Independent Auditor's Report

*[Same first and second paragraphs as the standard report ]*

(Explanatory paragraph)

With respect to the segment information in Note X, \$..... of the operating expenses of Industry A were incurred jointly by Industries A and B. In our opinion, generally accepted accounting principles require that those operating expenses be allocated between Industries A and B. The effect of the failure to allocate those operating expenses has been to understate the operating profit of Industry A and to overstate the operating profit of Industry B by an amount that has not been determined.

(Opinion paragraph)

In our opinion, except for the effects of not allocating certain common operating expenses between Industries A and B, as discussed in the preceding paragraph, the financial statements referred to above present fairly . . .

.10 If the entity declines to include in the financial statements part or all of the segment information that the auditor believes, based on his knowledge of the entity's business, is required to be disclosed, the auditor should modify his opinion on the financial statements because of inadequate disclosure and should describe the type of information omitted.<sup>[5]</sup> The auditor is not required to provide the omitted information in his report.<sup>[6]</sup> <sup>7</sup> The following is an example of an auditor's report qualified because of an omission of segment information.

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<sup>4</sup> The term "modify" in this context means to express a qualified or an adverse opinion.

<sup>[5]</sup> [Footnote deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>[6]</sup> [Footnote deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>7</sup> See section 508.55—58 for further discussion of the auditor's responsibility in these circumstances. [Footnote added to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

Independent Auditor's Report

[Same first and second paragraphs as the standard report ]

(Explanatory paragraph)

The Company declined to present segment information for the year ended December 31, 19XX. In our opinion, presentation of segment information concerning the Company's operations in different industries, its foreign operations and export sales, and its major customers is required by generally accepted accounting principles. The omission of segment information results in an incomplete presentation of the Company's financial statements.

(Opinion paragraph)

In our opinion, except for the omission of segment information, as discussed in the preceding paragraph, the financial statements referred to above present fairly . . .

**Consistency**

.11 Paragraph 67 of FASB Statement No. 14, states:

... consistency from period to period in the methods by which an enterprise's segment information is prepared and presented is as important as consistency in the application of the accounting principles used in preparing the enterprise's consolidated financial statements.

An inconsistency in segment information may occur because of—

- a. A change in the bases of accounting for sales or transfers between industry segments or between geographic areas, or in the methods of allocating operating expenses or identifiable assets among industry segments or geographic areas (paragraphs 23, 24, and 35a of FASB Statement No. 14 [AC sections S20.129—.130 and S20.141a]).
- b. A change in the method of determining or presenting a measure of profitability for some or all of the segments (paragraphs 25 and 35b of FASB Statement No. 14 [AC sections S20.131 and S20.141b]).
- c. A change in accounting principle as discussed in APB Opinion No. 20 [AC section A06], *Accounting Changes* (paragraph 27d of FASB Statement No. 14 [AC section S20.133d]).
- d. A change requiring retroactive restatement as discussed in paragraph .12 of this section.

.12 Paragraph 40 of FASB Statement No. 14 [AC section S20.146] requires that segment information for prior periods that is disclosed in comparative financial statements be retroactively restated if—

- a. The financial statements of the entity as a whole have been retroactively restated.
- b. The method of grouping products and services into industry segments or of grouping foreign operations into geographic areas is changed and the change affects the segment information disclosed.

.13 FASB Statement No. 14 [AC section S20] requires that the nature and effect of the changes indicated in paragraphs .11 and .12 be disclosed in the period of the change. If the nature and effect of a change are not disclosed or, if applicable, the segment information is not retroactively restated, the auditor should modify his opinion because of the departure from generally accepted accounting principles. The following is an example of an auditor's

report qualified because of an entity's failure to disclose the nature and effect of a change in the basis of accounting for sales between industry segments.

Independent Auditor's Report

[Same first and second paragraphs as the standard report ]

(Explanatory paragraph)

In 19XX, the Company changed the basis of accounting for sales between its industry segments from the market price method to the negotiated price method, but declined to disclose the nature and effect of this change on its segment information. In our opinion, disclosure of the nature and effect of this change, which has not been determined, is required by generally accepted accounting principles.

(Opinion paragraph)

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly . . .

.14 The addition of an explanatory paragraph (following the opinion paragraph) to the auditor's report because of lack of consistency is not required for the changes indicated in paragraphs .11 and .12 except for a change in accounting principle that affects the financial statements taken as a whole (paragraph .11c), in which case the auditor should also follow the guidance in sections 420 and 508.

### Scope Limitation

.15 An entity may represent to the auditor that it does not have industry segments, foreign operations, export sales, or major customers required to be disclosed by FASB Statement No. 14 [AC section S20]. The auditor ordinarily would be able to conclude, based on his knowledge of the entity's business, whether the entity has such industry segments, foreign operations, export sales, or major customers. If the auditor is unable to reach a conclusion based on that knowledge and the entity declines to develop the information he considers necessary to reach a conclusion, the auditor should indicate in the scope paragraph of his report the limitation on his audit and should qualify his opinion on the financial statements taken as a whole. The following is an example of an auditor's report qualified because of the auditor's inability to conclude whether the entity is required to present segment information.

Independent Auditor's Report

[Same first paragraph as the standard report ]

(Scope paragraph)

. . . Except as discussed in the following paragraph, we conducted our audit in accordance with . . .

(Explanatory paragraph)

The Company has not developed the information we consider necessary to reach a conclusion as to whether the presentation of segment information concerning the Company's operations in different industries, its foreign operations and export sales, and its major customers is necessary to conform to generally accepted accounting principles.

## (Opinion paragraph)

In our opinion, except for the possible omission of segment information, the financial statements referred to above present fairly . . .

**.16** The auditor should also qualify his opinion on the financial statements taken as a whole if he is unable to apply to reported segment information the auditing procedures that he considers necessary in the circumstances. The following is an example of an auditor's report qualified because the entity has specified that the auditor should not apply to reported segment information the auditing procedures that he considered necessary in the circumstances.

Independent Auditor's Report

[Same first paragraph as the standard report]

## (Scope paragraph)

. . . Except as discussed in the following paragraph, we conducted our audit in accordance with . . .

## (Explanatory paragraph)

In accordance with the Company's request, our audit of the financial statements did not include the segment information presented in Note X concerning the Company's operations in different industries, its foreign operations and export sales, and its major customers.

## (Opinion paragraph)

In our opinion, except for the effects of such adjustments or disclosures, if any, as might have been determined to be necessary had we applied to the segment information the procedures we considered necessary in the circumstances, the financial statements referred to above present fairly . . .

**Reporting Separately on Segment Information**

**.17** The auditor may be requested to report separately on segment information, either in a special report or as part of his report on the financial statements taken as a whole. In such an engagement, the measurement of materiality should be related to the segment information itself rather than to the financial statements taken as a whole. Consequently, an audit of segment information for the purpose of reporting on it separately is more extensive than if the same information were considered in conjunction with an audit of the financial statements taken as a whole.

**.18** Paragraphs .11—.17 of section 623, *Special Reports*, provide guidance that is applicable to reporting separately on segment information. However, all of the generally accepted auditing standards, including the first and second standards of reporting, are applicable because FASB Statement No. 14 [AC section S20] establishes generally accepted accounting principles for the presentation of segment information. Thus, whether segment information is presented voluntarily or because it is required, the auditor's report on such information should state whether it is presented in accordance with generally accepted accounting principles.

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## AU Section 500

# THE FOURTH STANDARD OF REPORTING

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... association with financial statements ... reports on audited financial statements ... dating of independent auditor's report ... reporting on financial statements prepared for use in other countries ... part of audit made by other independent auditors ... lack of conformity with GAAP ... other information in documents containing audited financial statements ... reporting on information in auditor-submitted documents ... reporting on condensed financial statements and selected financial data ... supplementary information ... subsequent events ... subsequent discovery of facts ...

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## AU Section 504

### ***Association With Financial Statements***

(Supersedes Statement on Auditing Standards No. 1, Sections 516, 517, and 518 and Statement on Auditing Standards No. 15, paragraphs 13—15)<sup>[1]</sup>

Sources: SAS No. 26; SAS No. 35.

See section 9504 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1979.

.01 The fourth standard of reporting is:

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, and the degree of responsibility, if any, the auditor is taking.

The objective of the fourth reporting standard is to prevent misinterpretation of the degree of responsibility the accountant assumes when his name is associated with financial statements.

.02 This section defines *association* as that term is used in the fourth reporting standard. It provides guidance to an accountant associated with the financial statements of a public entity or with a nonpublic entity's financial statements that he has been engaged to audit in accordance with generally accepted auditing standards.<sup>2</sup>

.03 An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements.<sup>3</sup> Also, when an accountant submits to his client or others financial statements that he has prepared or assisted in preparing, he is deemed to be associated even though the accountant does not append his name to the statements. Although the accountant may participate in the preparation of financial statements, the statements are representations of management, and the fairness of their presentation in conformity with generally accepted accounting principles is management's responsibility.

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<sup>[1]</sup> [Footnote deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>2</sup> For purposes of this section, a public entity is any entity (a) whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (c) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b). Statements on Standards for Accounting and Review Services provide guidance in connection with the unaudited financial statements or other unaudited financial information of a nonpublic entity.

<sup>3</sup> However, this section does not apply to data, such as tax returns, prepared solely for submission to taxing authorities.

.04 An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in section 508, *Reports on Audited Financial Statements*. The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in section 722, *Interim Financial Information*.

## **Disclaimer of Opinion on Unaudited Financial Statements**

.05 When an accountant is associated with the financial statements of a public entity, but has not audited or reviewed<sup>4</sup> such statements, the form of report to be issued is as follows:

The accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

(Signature and date)

This disclaimer of opinion is the means by which the accountant complies with the fourth standard of reporting when associated with unaudited financial statements in these circumstances. The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited. When an accountant issues this form of disclaimer of opinion, he has no responsibility to apply any procedures beyond reading the financial statements for obvious material misstatements. Any procedures that may have been applied should not be described, except in the limited circumstances set forth in paragraphs .18—.20. Describing procedures that may have been applied might cause the reader to believe the financial statements have been audited or reviewed.

.06 If the accountant is aware that his name is to be included in a client-prepared written communication of a public entity containing financial statements that have not been audited or reviewed, he should request (a) that his name not be included in the communication or (b) that the financial statements be marked as unaudited and that there be a notation that he does not express an opinion on them. If the client does not comply, the accountant should advise the client that he has not consented to the use of his name and should consider what other actions might be appropriate.<sup>5</sup>

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<sup>4</sup> When a public entity does not have its annual financial statements audited, an accountant may be requested to review its annual or interim financial statements. In those circumstances, an accountant may make a review and look to the guidance in Statements on Standards for Accounting and Review Services for the standards and procedures and form of report applicable to such an engagement.

<sup>5</sup> In considering what actions, if any, may be appropriate in the circumstances, the accountant may wish to consult his legal counsel.

## Disclaimer of Opinion on Unaudited Financial Statements Prepared on a Comprehensive Basis of Accounting

.07 When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, he should follow the guidance provided by paragraph .05, except that he should modify the identification of financial statements in his disclaimer of opinion (see section 623.02—.10, *Special Reports*).<sup>6</sup> For example, a disclaimer of opinion on cash-basis statements might be worded as follows:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 19X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

(Signature and date)

A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

## Disclaimer of Opinion When Not Independent

.08 The second general standard requires that “In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.” The independent public accountant must be without bias with respect to the client; otherwise, he would lack that impartiality necessary for the dependability of his findings. Whether the accountant is independent is something he must decide as a matter of professional judgment.

.09 When an accountant is not independent, any procedures he might perform would not be in accordance with generally accepted auditing standards, and he would be precluded from expressing an opinion on such statements. Accordingly, he should disclaim an opinion with respect to the financial statements and should state specifically that he is not independent.

.10 If the financial statements are those of a nonpublic entity, the accountant should look to the guidance in Statements on Standards for Accounting and Review Services. In all other circumstances, regardless of the extent of procedures applied, the accountant should follow the guidance in paragraph .05, except that the disclaimer of opinion should be modified to state specifically that he is not independent. The reasons for lack of independence and any procedures he has performed should not be described; including such matters might confuse the reader concerning the importance of the impairment of independence. An example of such a report is as follows:

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

(Signature and date)

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<sup>6</sup> Reference to generally accepted accounting principles in this section includes, where applicable, another comprehensive basis of accounting.

### **Circumstances Requiring a Modified Disclaimer**

.11 If the accountant concludes on the basis of facts known to him that the unaudited financial statements on which he is disclaiming an opinion are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should suggest appropriate revision; failing that, he should describe the departure in his disclaimer of opinion. This description should refer specifically to the nature of the departure and, if practicable, state the effects on the financial statements or include the necessary information for adequate disclosure.

.12 When the effects of the departure on the financial statements are not reasonably determinable, the disclaimer of opinion should so state. When a departure from generally accepted accounting principles involves inadequate disclosure, it may not be practicable for the accountant to include the omitted disclosures in his report. For example, when management has elected to omit substantially all of the disclosures, the accountant should clearly indicate that in his report, but the accountant would not be expected to include such disclosures in his report.

.13 If the client will not agree to revision of the financial statements or will not accept the accountant's disclaimer of opinion with the description of the departure from generally accepted accounting principles, the accountant should refuse to be associated with the statements and, if necessary, withdraw from the engagement.

### **Reporting on Audited and Unaudited Financial Statements in Comparative Form**

.14 When unaudited financial statements are presented in comparative form with audited financial statements in documents filed with the Securities and Exchange Commission, such statements should be clearly marked as "unaudited" but should not be referred to in the auditor's report.

.15 When unaudited financial statements are presented in comparative form with audited financial statements in any other document, the financial statements that have not been audited should be clearly marked to indicate their status and either (a) the report on the prior period should be reissued (see section 530.06—.08)<sup>7</sup> or (b) the report on the current period should include as a separate paragraph an appropriate description of the responsibility assumed for the financial statements of the prior period (see paragraphs .16 and .17). Either reissuance or reference in a separate paragraph is acceptable; in both circumstances, the accountant should consider the current form and manner of presentation of the financial statements of the prior period in light of the information of which he has become aware during his current engagement.

.16 When the financial statements of the prior period have been audited and the report on the current period is to contain a separate paragraph, it should indicate (a) that the financial statements of the prior period were audited previously, (b) the date of the previous report, (c) the type of opinion expressed previously, (d) if the opinion was other than unqualified, the substantive reasons therefor, and (e) that no auditing procedures were performed after the date of the previous report. An example of such a separate paragraph is as follows:

The financial statements for the year ended December 31, 19X1, were audited by us (other accountants) and we (they) expressed an unqualified

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<sup>7</sup> For reissuance of a compilation or review report, see Statements on Standards for Accounting and Review Services.



opinion on them in our (their) report dated March 1, 19X2, but we (they) have not performed any auditing procedures since that date.

.17 When the financial statements of the prior period have not been audited and the report on the current period is to contain a separate paragraph, it should include (a) a statement of the service performed in the prior period, (b) the date of the report on that service, (c) a description of any material modifications noted in that report, and (d) a statement that the service was less in scope than an audit and does not provide the basis for the expression of an opinion on the financial statements taken as a whole. When the financial statements are those of a public entity, the separate paragraph should include a disclaimer of opinion (see paragraph .05) or a description of a review. When the financial statements are those of a nonpublic entity and the financial statements were compiled or reviewed, the separate paragraph should contain an appropriate description of the compilation or review. For example, a separate paragraph describing a review might be worded as follows:

The 19X1 financial statements were reviewed by us (other accountants) and our (their) report thereon, dated March 1, 19X2, stated we (they) were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

A separate paragraph describing a compilation might be worded as follows:

The 19X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 19X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

## Negative Assurance

.18 When an accountant, for whatever reason, disclaims an opinion on financial statements his disclaimer should not be contradicted by the inclusion of expressions of assurance on the absence of knowledge of departures from generally accepted accounting principles except as specifically recognized as appropriate in applicable standards established by the American Institute of Certified Public Accountants.

.19 Negative assurances, for example, are permissible in letters for underwriters in which the independent auditor reports on limited procedures followed with respect to unaudited financial statements or other financial data pertinent to a registration statement filed with the Securities and Exchange Commission (see section 634,\* *Letters for Underwriters*).

.20 An accountant may also be requested to describe limited procedures followed with respect to unaudited financial statements of a public entity, similar to those performed for a letter for underwriters, in connection with a proposed acquisition and give negative assurance regarding the financial statements taken as a whole. Acceptance and performance of such an engagement is appropriate if the applicable requirements for a letter for underwriters are met (see section 634\*). When an accountant is requested to report on the results of applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement in connection with a proposed acquisition, he should report in accordance with section 622.\*\* [As amended, April 1981, by Statement on Auditing Standards No. 35.] (See section 622.)

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[The next page is 611.]

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\* [Reference number 631, formerly 630, changed by the issuance of Statement on Auditing Standards No. 38 (superseded). Reference number 634, formerly 631, changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

\*\* [Reference changed by issuance of Statement on Auditing Standards No. 35.] (See section 622.)

**AU Section 9504*****Association With Financial Statements:  
Auditing Interpretations of Section 504*****1. Annual Report Disclosure of Unaudited Fourth Quarter Interim Data**

**.01 Question**—APB Opinion No. 28, paragraph 31 [AC section I73.147], which applies to publicly traded companies, states: “When interim financial data and disclosures are not separately reported for the fourth quarter, security holders often make inferences about that quarter by subtracting data based on the third quarter interim report from the annual results. In the absence of a separate fourth quarter report or disclosure of the results . . . for that quarter in the annual report, disposals of segments of a business and extraordinary, unusual, or infrequently occurring items recognized in the fourth quarter, as well as the aggregate effect of year-end adjustments which are material to the results of that quarter . . . should be disclosed in the annual report in a note to the annual financial statements.” Does the auditor have an obligation, arising from the disclosure requirements of paragraph 31 of Opinion No. 28 [AC section I73.147], to audit interim data?

**.02 Interpretation**—No. If the auditor has not been specifically engaged to audit interim information, he does not have an obligation to audit interim data as a result of his audit of the annual financial statements.

**.03** Disclosure of fourth quarter adjustments and other disclosures required by paragraph 31 [AC section I73.147] would appear in a note to the annual financial statements of a publicly traded company only if fourth quarter data were not separately distributed or did not appear elsewhere in the annual report. Consequently, such disclosures are not essential for a fair presentation of the annual financial statements in conformity with generally accepted accounting principles.

**.04** If interim financial data and disclosures are not separately reported (as outlined in paragraph 30 of Opinion No. 28 [AC section I73.146]) for the fourth quarter, the independent auditor, during his audit of the annual financial statements, should inquire as to whether there are fourth quarter items that need to be disclosed in a note to the annual financial statements.

**.05** Information on fourth quarter adjustments and similar items that appear in notes to the annual financial statements to comply with paragraph 31 of Opinion No. 28 [AC section I73.147] would ordinarily not be audited separately and, therefore, the information would be labeled “unaudited” or “not covered by auditor’s report.”

**.06** If a publicly traded company fails to comply with the provisions of paragraph 31 of Opinion No. 28 [AC section I73.147], the auditor should suggest appropriate revision; failing that, he should call attention in his report to the omission of the information. The auditor need not qualify his opinion on the annual financial statements since the disclosure is not essential for a fair presentation of those statements in conformity with generally accepted accounting principles.

**.07** Reference should be made to section 722 for guidance with respect to reviews of interim financial information of public entities.

[Issue Date: November, 1979.]

**[2.] Association of the Auditor of an Acquired Company With Unaudited Statements in a Listing Application**

[.08—.12] [Deleted May, 1980.]

**[3.] Association of the Auditor of the Acquiring Company With Unaudited Statements in a Listing Application**

[.13—.14] [Deleted May, 1980.]

**4. Auditor's Identification With Condensed Financial Data**

**.15 Question**—Section 150.02 states in part: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking." Section 504.03 states that "An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements." Is the auditor "associated" with condensed financial data when he is identified by a financial reporting service as being a company's independent auditor or when his report is reproduced and presented with such data?

**.16 Interpretation**—No. The accountant has not consented to the use of his name when it is published by a financial reporting service. Financial data released to the public by a company and the name of its auditor are public information. Accordingly, neither the auditor nor his client has the ability to require a financial reporting service to withhold publishing such information.

**.17** Financial reporting services, such as Dun & Bradstreet and Moody's Investors Service, furnish to subscribers information and ratings concerning commercial enterprises as a basis for credit, insurance, marketing and other business purposes. Those reports frequently include condensed financial data and other data such as payments to trade creditors, loan experience with banks, a brief history of the entity and a description of its operations. Also, as part of its report, the financial service often discloses the names of the officers and directors or principals or owners of the company and the name of the company's auditor.

**.18** In the context in which the auditor's name appears, it is doubtful that readers will assume that he has audited the information presented. However, the AICPA has suggested to certain financial reporting services that they identify data as "unaudited" if the data has been extracted from unaudited financial statements. Also, the AICPA has suggested that when summarized financial data is presented together with an auditor's report on complete financial statements (including notes), the financial reporting services state that the auditor's report applies to financial statements not presented.

[Issue Date: November, 1979.]

**5. Applicability of Guidance on Reporting When Not Independent**

**.19 Question**—Section 504 describes the reporting responsibilities of the certified public accountant who has determined that he is not independent

with respect to financial statements with which he is associated. That section, however, does not indicate how he should determine whether he is independent. What should the certified public accountant consider in determining whether he is independent? Also, should his consideration be any different for an engagement to prepare unaudited financial statements?

**.20 Interpretation**—Section 504 explains the certified public accountant's reporting responsibilities when he is not independent. However, it does not attempt to explain how the certified public accountant determines whether he is independent because that is a question of professional ethics. Section 220.04 states: "The profession has established, through the AICPA Code of Professional Conduct, precepts to guard against the . . . loss of independence." The AICPA, state CPA societies and state boards of accountancy have issued pronouncements to provide the certified public accountant with guidance to aid him in determining whether he is independent.

**.21** The certified public accountant should consider the AICPA's Code of Professional Conduct in determining whether he is independent and whether the reporting requirements of section 504 apply. He should also consider the ethical requirements of his state CPA society or state board of accountancy.

**.22** Section 504.10 states that the reporting guidance applies, *regardless of the extent of procedures applied*, (emphasis added) in all circumstances other than when the financial statements are those of a non-public entity.<sup>1</sup> Thus, the accountant's consideration of whether he is independent should be the same whether the financial statements are audited or unaudited.

[Issue Date: November, 1979.]

## **[6.] Reporting on Solvency<sup>[2]</sup>**

**[.23—.35]** [Rescinded May, 1988 by the issuance of attestation interpretation, "Responding to Requests for Reports on Matters Relating to Solvency."] (See AT section 9100.28—.41.)

[The next page is 651.]

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<sup>1</sup> If the financial statements are those of a non-public entity, the accountant should look to the guidance in Statements on Standards for Accounting and Review Services.

<sup>[2]</sup> [Rescinded May, 1988 by the issuance of attestation interpretation "Responding to Requests for Reports on Matters Relating to Solvency."] (See AT section 9100.28—.41.)

## AU Section 508

# Reports on Audited Financial Statements

(Supersedes sections 505, 509, 542, 545, and 546)

Source: SAS No. 58; SAS No. 64.

Effective for reports issued or reissued on or after January 1, 1989, unless otherwise indicated.

### Introduction

.01 This section applies to auditors' reports issued in connection with audits<sup>1</sup> of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.

.02 This section does not apply to unaudited financial statements as described in section 504, *Association With Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in section 623, *Special Reports*.

.03 Justification for the expression of the auditor's opinion rests on the conformity of his audit with generally accepted auditing standards and on his findings. Generally accepted auditing standards include four standards of reporting.<sup>2</sup> This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.

.04 The fourth standard of reporting is as follows:

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, and the degree of responsibility the auditor is taking.

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<sup>1</sup> An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with generally accepted auditing standards in effect at the time the audit is performed. Generally accepted auditing standards include the ten standards as well as the Statements on Auditing Standards that interpret those standards. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.

<sup>2</sup> This section revises the second standard of reporting as follows:

The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period. Previously, the second standard required the auditor's report to state whether accounting principles had been consistently applied. As revised, the second standard requires the auditor to add an explanatory paragraph to his report only if accounting principles have not been applied consistently. (See section 420, *Consistency of Application of Generally Accepted Accounting Principles*.) Paragraphs .34—.36 of this section provide reporting guidance under these circumstances.

.05 The objective of the fourth standard is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his name is associated with financial statements. Reference in the fourth reporting standard to the financial statements “taken as a whole” applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .74 discusses the fourth standard of reporting as it applies to comparative financial statements.) The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.

.06 The auditor’s report is customarily issued in connection with an entity’s basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor’s report. If the basic financial statements include a separate statement of changes in stockholders’ equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.

## The Auditor’s Standard Report

.07 The auditor’s standard report states that the financial statements present fairly, in all material respects, an entity’s financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.

.08 The auditor’s standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor’s opinion in a separate opinion paragraph. The basic elements of the report are the following:

- a. A title that includes the word *independent*<sup>3</sup>
- b. A statement that the financial statements identified in the report were audited
- c. A statement that the financial statements are the responsibility of the Company’s management<sup>4</sup> and that the auditor’s responsibility is to express an opinion on the financial statements based on his audit
- d. A statement that the audit was conducted in accordance with generally accepted auditing standards
- e. A statement that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement
- f. A statement that an audit includes—

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<sup>3</sup> This section does not require a title for an auditor’s report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent.

<sup>4</sup> In some instances, a document containing the auditor’s report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor’s report should state that the financial statements are management’s responsibility.

- (1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements
  - (2) Assessing the accounting principles used and significant estimates made by management
  - (3) Evaluating the overall financial statement presentation<sup>5</sup>
- g. A statement that the auditor believes that his audit provides a reasonable basis for his opinion
  - h. An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles
  - i. The manual or printed signature of the auditor's firm
  - j. The date<sup>6</sup> of the audit report

The form of the auditor's standard report on financial statements covering a single year is as follows:

#### Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

The form of the auditor's standard report on comparative financial statements<sup>7</sup> is as follows:

#### Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income,

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<sup>5</sup> Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, paragraphs .03 and .04, discuss the auditor's evaluation of the overall presentation of the financial statements.

<sup>6</sup> For guidance on dating the auditor's report, see section 530, *Dating of the Independent Auditor's Report*.

<sup>7</sup> If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such as "for each of the three years in the period ended [date of latest balance sheet]."

retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

**.09** The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not his client; in such a case, the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.

**.10** This section also discusses the circumstances that may require the auditor to depart from the standard report and provides reporting guidance in such circumstances. This section is organized by type of opinion that the auditor may express in each of the various circumstances presented; this section describes what is meant by the various audit opinions:

- *Unqualified opinion.* An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.
- *Explanatory language added to the auditor's standard report.* Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his report.
- *Qualified opinion.* A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.
- *Adverse opinion.* An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles.



- **Disclaimer of opinion.** A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

These opinions are discussed in greater detail throughout the remainder of this section.

## Explanatory Language Added to the Auditor's Standard Report

.11 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory<sup>8</sup> paragraph (or other explanatory language) to his standard report.<sup>9</sup> These circumstances include:

- a. The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).
- b. To prevent the financial statements from being misleading because of unusual circumstances, the financial statements contain a departure from an accounting principle promulgated by a body designated by the AICPA Council to establish such principles (paragraphs .14 and .15).
- c. The financial statements are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditor's report (paragraphs .16—.33).
- d. There is substantial doubt about the entity's ability to continue as a going concern.<sup>10</sup>
- e. There has been a material change between periods in accounting principles or in the method of their application (paragraphs .34—.36).
- f. Certain circumstances relating to reports on comparative financial statements exist (paragraphs .77, .78, and .81—.83).
- g. Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (See section 722, *Interim Financial Information*, paragraph .41.) [Reference changed by the issuance of Statement on Auditing Standards No. 71.]
- h. Supplementary information required by the Financial Accounting Standards Board (FASB) or the Governmental Accounting Standards Board (GASB) has been omitted, the presentation of such information departs materially from FASB or GASB guidelines, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB or GASB guidelines. (See section 558, *Required Supplementary Information*, paragraph .02.)
- i. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the

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<sup>8</sup> Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report.

<sup>9</sup> See footnote 3.

<sup>10</sup> Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in his report to reflect his conclusions.

financial statements. (See section 550, *Other Information in Documents Containing Audited Financial Statements*, paragraph .04.)

In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .37).

### Opinion Based in Part on Report of Another Auditor

.12 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his opinion, he should disclose this fact in the introductory paragraph of his report and should refer to the report of the other auditor in expressing his opinion. These references indicate division of responsibility for performance of the audit. (See section 543, *Part of Audit Performed by Other Independent Auditors*.)

.13 An example of a report indicating a division of responsibility follows:

#### Independent Auditor's Report

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X2 and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of \$\_\_\_\_\_ and \$\_\_\_\_\_ as of December 31, 19X2 and 19X1, respectively, and total revenues of \$\_\_\_\_\_ and \$\_\_\_\_\_ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 19X2 and 19X1, and the results of their operations and their cash flows for the years then ended in conformity with generally accepted accounting principles.

### Departure From a Promulgated Accounting Principle

.14 Rule 203 [ET section 203.01] of the Code of Professional Conduct of the AICPA states:

A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally

accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

.15 When the circumstances contemplated by Rule 203 [ET section 203.01] are present, the auditor's report should include, in a separate paragraph or paragraphs, the information required by the rule. In such a case, it is appropriate for him to express an unqualified opinion with respect to the conformity of the financial statements with generally accepted accounting principles unless there are other reasons, not associated with the departure from a promulgated principle, not to do so. (See section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*.)

## Uncertainties

.16 This section (paragraphs .17 through .33) provides guidance on the auditor's considerations in deciding whether an explanatory paragraph needs to be added to his report because of a matter involving an uncertainty.<sup>11</sup> Such uncertainties include, but are not limited to, contingencies covered by FASB Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies* [AC section C59]. This section also provides guidance on distinguishing between (a) situations involving uncertainties for which an explanatory paragraph in the auditor's report is necessary, and (b) those for which a qualified opinion or a disclaimer of opinion is necessary because of a scope limitation or those for which a qualified or adverse opinion is necessary because of a departure from generally accepted accounting principles.

### Distinguishing Between Situations That May Require an Explanatory Paragraph and Those That May Require a Departure From an Unqualified Opinion

.17 **Uncertainties and scope limitations.** If the auditor has not obtained sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, he should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation (see paragraphs .40 through .48). In making that determination, the auditor should consider the distinction between a scope limitation (described below) and the need for an explanatory paragraph because of an uncertainty (see paragraphs .23 through .26).

.18 A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time sufficient evidential matter concerning its outcome would be expected to become available. A qualification or disclaimer of opinion because of a scope limitation is appropriate when

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<sup>11</sup> The addition of an explanatory paragraph to the auditor's report to identify an uncertainty, as contemplated by this section, serves adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner, and the auditor's report should give all the substantive reasons for his disclaimer of opinion.

sufficient evidential matter does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management. However, the auditor should recognize that, although sufficient evidential matter concerning the outcome of an uncertainty cannot be expected to exist at the time of the audit (because the resolution, and therefore the evidence, is prospective), it is management's responsibility when preparing the financial statements in conformity with generally accepted accounting principles to analyze relevant existing conditions and their effect on the financial statements. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis.

**.19 *Uncertainties and departures from generally accepted accounting principles.*** Departures from generally accepted accounting principles involving uncertainties generally fall into one of the following categories:

- Inadequate disclosure (paragraph .20)
- Inappropriate accounting principles (paragraph .21)
- Unreasonable accounting estimates (paragraph .22)

**.20** If the auditor concludes that a matter involving an uncertainty is not adequately disclosed in the financial statements in conformity with generally accepted accounting principles, he should qualify his opinion or express an adverse opinion.

**.21** In preparing financial statements, management estimates the outcome of certain types of future events. For example, estimates customarily are made about the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the provision for product warranties. SFAS No. 5, paragraphs 23 and 25 [AC section C59.129 and .131], discusses situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, he should express a qualified or adverse opinion.

**.22** Usually, the auditor is able to satisfy himself regarding the reasonableness of management's estimate of the effects of future events by considering various types of evidential matter, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable (see section 312, *Audit Risk and Materiality in Conducting an Audit*, and section 342, *Auditing Accounting Estimates*) and that its effect is to cause the financial statements to be materially misstated, he should express a qualified or an adverse opinion.

### **Situations Involving Uncertainties That May Require an Explanatory Paragraph**

**.23** In certain instances, however, the outcome of future events that may affect the financial statements, including required disclosures, is not susceptible of reasonable estimation by management. When such uncertainties exist, it cannot be determined whether the financial statements should be adjusted or in what amount. Such matters are to be regarded as uncertainties for purposes of considering the need for an explanatory paragraph in the auditor's report. In deciding whether to add an explanatory paragraph to the report because of a matter involving an uncertainty (other than a going concern matter), the auditor considers the likelihood of a material loss resulting from the resolution of the uncertainty.

**.24 Remote likelihood of a material loss.** If management believes and the auditor is satisfied that there is only a remote likelihood of a material loss resulting from resolution of a matter involving an uncertainty, the auditor would not add an explanatory paragraph to his report because of the matter.

**.25 Probable chance of material loss.** If management believes and the auditor is satisfied that it is probable that a material loss will occur, but management is unable to make a reasonable estimate of the amount or range of potential loss and thus has not made an accrual in the financial statements, the auditor should add an explanatory paragraph to his report because of the matter involving an uncertainty.<sup>12</sup> In some cases, management may, in accordance with generally accepted accounting principles, accrue the estimable portion of a probable loss. In such circumstances, the auditor should decide whether to add an explanatory paragraph to his report by considering the matters described in paragraph .26 with respect to the unrecorded amount of the loss.

**.26 Reasonable possibility of a material loss.** If management believes and the auditor is satisfied that the chance of a material loss resulting from resolution of a matter involving an uncertainty is more than remote but less than probable, the auditor should consider the following matters in deciding whether to add an explanatory paragraph to his report:

- The magnitude by which the amount of reasonably possible loss exceeds the auditor's judgment about materiality
- The likelihood of occurrence of a material loss (for example, whether that likelihood is closer to remote or to probable)

The auditor is more likely to add an explanatory paragraph to his report as the amount of reasonably possible loss becomes larger or the likelihood of occurrence of a material loss increases.

### Materiality Considerations

**.27** The auditor should consider materiality in planning the audit and in evaluating whether the financial statements taken as a whole are presented fairly in conformity with generally accepted accounting principles. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of the uncertainties both individually and in the aggregate. He performs that evaluation without regard to his evaluation of the materiality of likely error in the financial statements.

**.28** The auditor's consideration of materiality is a matter of professional judgment and is influenced by his perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving uncertainties are made in light of the surrounding circumstances. Some uncertainties relate primarily to financial position, while others more closely relate to results of operations or cash flows. Thus, for purposes of evaluating the materiality of a possible loss, the auditor should consider which, if any, of the financial statements is the more appropriate base in the circumstances.

**.29** Some uncertainties are unusual in nature or infrequent in occurrence and thus more closely related to financial position than to normal, recurring operations (for example, litigation relating to alleged violations of antitrust or securities laws). In such instances, the auditor should consider the possible loss in relation to shareholder's equity and other relevant balance sheet compo-

<sup>12</sup> However, the auditor should consider whether the inability to make an estimate raises questions as to the appropriateness of accounting principles used (see paragraph .21).

nents such as total assets, total liabilities, current assets, and current liabilities.

.30 In other instances, the nature of an uncertainty may be more closely related to normal, recurring operations (for example, litigation with a party to a royalty agreement concerning whether a royalty fee should be paid on certain revenues). In such circumstances, the auditor should consider the possible loss in relation to relevant income statement components, such as income from continuing operations.

### **Explanatory Paragraph Added to the Report**

.31 If, after applying the criteria in paragraphs .24 through .30, the auditor has concluded that he should include an explanatory paragraph (following the opinion paragraph) in his report,<sup>13</sup> he should describe the matter giving rise to the uncertainty in the explanatory paragraph and indicate that its outcome cannot presently be determined. The separate paragraph(s) may be shortened by referring to disclosures made in a note to the financial statements. However, no reference to the uncertainty should be made in the introductory, scope or opinion paragraphs of his report.<sup>14</sup>

.32 An example of an explanatory paragraph (following the opinion paragraph) describing an uncertainty follows:

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

.33 The subsequent resolution of an uncertainty that has led to the addition of an explanatory paragraph to the auditor's report will usually (a) be recognized in the financial statements of a subsequent period, or (b) result in a conclusion that the matter has no material monetary effect on the financial statements of any period. In rare cases, the subsequent resolution may result in adjustment of the financial statements related to the report in which the auditor originally included the explanatory paragraph. However, the paragraph that discusses the uncertainty in the auditor's report should be the same regardless of the accounting treatment expected to be accorded the resolution of the uncertainty.

### **Lack of Consistency**

.34 The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods because either (a) no change in accounting principles has occurred, or (b) there has been a change in accounting principles or in the method of their application, but the effect of the change on the comparability of the financial statements is not material. In these cases, the auditor should not refer to consistency in his report. If, however, there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of

<sup>13</sup> Use of the term "subject to" to qualify an opinion because of an uncertainty is no longer permissible under the provisions of this section.

<sup>14</sup> An explanatory paragraph following the opinion paragraph is not necessary when the auditor qualifies his opinion because of a GAAP departure related to an uncertainty and the paragraph that explains the reason for the qualification includes information that would otherwise be required in an explanatory paragraph following the opinion paragraph.

the company's financial statements, the auditor should refer to the change in an explanatory paragraph of his report. Such explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer the reader to the note in the financial statements that discusses the change in detail. The auditor's concurrence with a change is implicit unless he takes exception to the change in expressing his opinion as to fair presentation of the financial statements in conformity with generally accepted accounting principles.<sup>15</sup> When there is a change in accounting principles, there are also other matters that the auditor should consider (see paragraphs .59 through .66).

**.35** Following is an example of an appropriate explanatory paragraph:

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 19X2.

**.36** The addition of this explanatory paragraph in the auditor's report is required in reports on financial statements of subsequent years as long as the year of the change is presented and reported on.<sup>16</sup> However, if the accounting change is accounted for by retroactive restatement of the financial statements affected, the additional paragraph is required only in the year of the change since, in subsequent years, all periods presented will be comparable.

### Emphasis of a Matter

**.37** In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. For example, he may wish to emphasize that the entity is a component of a larger business enterprise or that it has had significant transactions with related parties, or he may wish to emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type.

## Departures From Unqualified Opinions

### Qualified Opinions

**.38** Certain circumstances may require a qualified opinion. A qualified opinion states that, *except for* the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when—

- a. There is a lack of sufficient competent evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he cannot express an unqualified opinion and he has concluded not to disclaim an opinion (paragraphs .40—.48).
- b. The auditor believes, on the basis of his audit, that the financial statements contain a departure from generally accepted accounting

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<sup>15</sup> With respect to the method of accounting for the effect of a change in accounting principle, see Accounting Principles Board Opinion No. 20, *Accounting Changes*, including paragraph 4 [AC section A06.103], which states that methods of accounting for changes in principles resulting from the implementation of new pronouncements is provided in those pronouncements.

<sup>16</sup> An exception to this requirement occurs when a change in accounting principle that does not require a cumulative effect adjustment is made at the beginning of the earliest year presented and reported on. That exception is addressed in the auditing interpretation of section 420, *Consistency of Application of Generally Accepted Accounting Principles*, titled "Impact on the Auditor's Report of FIFO to LIFO Change in Comparative Financial Statements," (section 9420.16—.23).

principles, the effect of which is material, and he has concluded not to express an adverse opinion (paragraphs .49—.66).

.39 When the auditor expresses a qualified opinion, he should disclose all of the substantive reasons in one or more separate explanatory paragraph(s) preceding the opinion paragraph of his report. He should also include, in the opinion paragraph, the appropriate qualifying language and a reference to the explanatory paragraph. A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used.

### Scope Limitations

.40 The auditor can determine that he is able to express an unqualified opinion only if his audit has been conducted in accordance with generally accepted auditing standards and if he has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of his audit, whether imposed by the client or by circumstances, such as the timing of his work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require him to qualify his opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.41 The auditor's decision to qualify his opinion or disclaim an opinion because of a scope limitation depends on his assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the financial statements being audited. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.

.42 Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors.<sup>17</sup> Another common scope restriction involves accounting for long-term investments when the auditor has not been able to obtain audited financial statements of an investee. Restrictions on the application of these or other audit procedures to important elements of the financial statements require the auditor to decide whether he has examined sufficient competent evidential matter to permit him to express an unqualified or qualified opinion, or whether he should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements.

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<sup>17</sup> Circumstances such as the timing of his work may make it impossible for the auditor to accomplish these procedures. In this case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not include a reference to the omission of the procedures or the use of alternative procedures. It is important to understand, however, that section 331, *Inventories*, states that "it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions."



**.43** When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the situation should be described in an explanatory paragraph preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of his client.

**.44** When an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and, therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

Independent Auditor's Report

*[Same first paragraph as the standard report ]*

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$\_\_\_\_\_ and \$\_\_\_\_\_ at December 31, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of \$\_\_\_\_\_ and \$\_\_\_\_\_, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

**.45 Other scope limitations.** Sometimes, notes to financial statements may contain unaudited information, such as pro forma calculations or other similar disclosures. If the unaudited information (for example, an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, the auditor should apply the procedures he deems necessary to the unaudited information. If the auditor has not been able to apply the procedures he considers necessary, he should qualify his opinion or disclaim an opinion because of a limitation on the scope of his audit.

**.46** If, however, these disclosures are not necessary to fairly present the financial position, operating results, or cash flows on which the auditor is

reporting, such disclosures may be identified as *unaudited* or as *not covered by the auditor's report*. For example, the pro forma effects of a business combination or of a subsequent event may be labelled unaudited. Therefore, while the event or transaction giving rise to the disclosures in these circumstances should be audited, the pro forma disclosures of that event or transaction would not be. The auditor should be aware, however, that section 530, *Dating of the Independent Auditor's Report*, states that, if the auditor is aware of a material subsequent event that has occurred after the completion of fieldwork but before issuance of the report that should be disclosed, his only options are to dual date the report or date the report as of the date of the subsequent event and extend the procedures for review of subsequent events to that date. Labelling the note unaudited is not an acceptable alternative in these circumstances.

**.47 Limited reporting engagements.** The auditor may be asked to report on one basic financial statement and not on the others. For example, he may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if he applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

**.48** An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself regarding the consistency of application of accounting principles):

#### Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 19XX, in conformity with generally accepted accounting principles.

#### **Departure From a Generally Accepted Accounting Principle**

**.49** When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with generally accepted auditing standards, he should express a qualified (paragraphs .50 through .66) or an adverse (paragraphs .67 through .69) opinion. The basis for such opinion should be stated in his report.

**.50** In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or adverse opinion, one factor to be considered is the dollar magni-

tude of such effects. However, the concept of materiality does not depend entirely on relative size; it involves qualitative as well as quantitative judgments. The significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

**.51** When the auditor expresses a qualified opinion, he should disclose, in a separate explanatory paragraph(s) preceding the opinion paragraph of his report, all of the substantive reasons that have led him to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the opinion paragraph of his report should include the appropriate qualifying language and a reference to the explanatory paragraph(s).

**.52** The explanatory paragraph(s) should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable.<sup>18</sup> If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the explanatory paragraph(s) may be shortened by referring to it.

**.53** An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

#### Independent Auditor's Report

*[Same first and second paragraphs as the standard report ]*

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$\_\_\_\_\_ and \$\_\_\_\_\_, long-term debt by \$\_\_\_\_\_ and \$\_\_\_\_\_, and retained earnings by \$\_\_\_\_\_ and \$\_\_\_\_\_ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_ and earnings per share would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

**.54** If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (preceding the opinion paragraph) of the auditor's report in the circumstances illustrated in paragraph .53 might read as follows:

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accom-

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<sup>18</sup> Section 431, *Adequacy of Disclosure in the Financial Statements*, defines *practicable* as "... the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information." For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in his report.

panying balance sheets. In our opinion, generally accepted accounting principles require that such obligations be included in the balance sheets.

**.55 *Inadequate disclosure.*** Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in his report, if practicable,<sup>19</sup> unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards.

**.56** Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

Independent Auditor's Report

*[Same first and second paragraphs as the standard report ]*

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .

**.57** If a company issues financial statements that purport to present financial position and results of operations but omits the related statement of cash flows, the auditor will normally conclude that the omission requires qualification of his opinion.

**.58** The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in his report if the company's management declines to present the statement. Accordingly, in these cases, the auditor should ordinarily qualify his report in the following manner:

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

*[Same second paragraph as the standard report ]*

The Company declined to present a statement of cash flows for the years ended December 31, 19X2 and 19X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by generally accepted accounting principles.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.

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<sup>19</sup> See footnote 18.

**.59 Accounting changes.** The auditor should evaluate a change in accounting principle to satisfy himself that (a) the newly adopted accounting principle is a generally accepted accounting principle, (b) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, and (c) management's justification for the change is reasonable. If a change in accounting principle does not meet these conditions, the auditor's report should so indicate, and his opinion should be appropriately qualified as discussed in paragraphs .60 and .61.

**.60** If (a) a newly adopted accounting principle is not a generally accepted accounting principle, (b) the method of accounting for the effect of the change is not in conformity with generally accepted accounting principles, or (c) management has not provided reasonable justification for the change in accounting principle, the auditor should express a qualified opinion or, if the effect of the change is sufficiently material, the auditor should express an adverse opinion on the financial statements.

**.61** Accounting Principles Board Opinion No. 20, *Accounting Changes*, paragraph 16 [AC section A06.112], states: "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable." If management has not provided reasonable justification for the change in accounting principles, the auditor should express an exception to the change having been made without reasonable justification. An example of a report qualified for this reason follows:

Independent Auditor's Report

*[Same first and second paragraphs as the standard report ]*

As disclosed in Note X to the financial statements, the Company adopted, in 19X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with generally accepted accounting principles, in our opinion the Company has not provided reasonable justification for making this change as required by generally accepted accounting principles.<sup>20</sup>

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

**.62** Whenever an accounting change results in an auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, he should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraph .63 through .66.

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<sup>20</sup> Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, states that a change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error and that such a change requires recognition in the auditor's report as to consistency. Therefore, the auditor should add an explanatory paragraph to his report discussing the accounting change.

However, because the middle paragraph included in the example presented contains all of the information required in an explanatory paragraph on consistency, a separate explanatory paragraph (following the opinion paragraph) as required by paragraphs .34 through .36 of this section is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs.

.63 If the financial statements for the year of such change are presented and reported on with a subsequent year's financial statements, the auditor's report should disclose his reservations with respect to the statements for the year of change.

.64 If an entity has adopted an accounting principle that is not a generally accepted accounting principle, its continued use might have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a qualified opinion or an adverse opinion, depending on the materiality of the departure in relation to the statements of the subsequent year.

.65 If an entity accounts for the effect of a change prospectively when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit that is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion.

.66 If management has not provided reasonable justification for a change in accounting principles, the auditor's opinion should express an exception to the change having been made without reasonable justification, as previously indicated. In addition, the auditor should continue to express his exception with respect to the financial statements for the year of change as long as they are presented and reported on. However, the auditor's exception relates to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing an exception for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express an exception to use of the newly adopted principle.

## Adverse Opinions

.67 An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles.

.68 When the auditor expresses an adverse opinion, he should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of his report (a) all the substantive reasons for his adverse opinion, and (b) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.<sup>21</sup> If the effects are not reasonably determinable, the report should so state.<sup>22</sup>

.69 When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion, as shown below:

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<sup>21</sup> See footnote 18.

<sup>22</sup> When the auditor expresses an adverse opinion, he should also consider the need for an explanatory paragraph under the circumstances identified in paragraph .11, subsections (c), (d), (e), and (f) of this section.

### Independent Auditor's Report

[Same first and second paragraphs as the standard report]

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from generally accepted accounting principles identified above, as of December 31, 19X2 and 19X1, inventories have been increased \$\_\_\_\_\_ and \$\_\_\_\_\_ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at \$\_\_\_\_\_ and \$\_\_\_\_\_ in excess of an amount based on the cost to the Company; and deferred income taxes of \$\_\_\_\_\_ and \$\_\_\_\_\_ have not been recorded; resulting in an increase of \$\_\_\_\_\_ and \$\_\_\_\_\_ in retained earnings and in appraisal surplus of \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively. For the years ended December 31, 19X2 and 19X1, cost of goods sold has been increased \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of \$\_\_\_\_\_ and \$\_\_\_\_\_ have not been provided, resulting in an increase in net income of \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

### **Disclaimer of Opinion**

.70 A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. It is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an opinion on the financial statements.<sup>23</sup> A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his audit, that there are material departures from generally accepted accounting principles (see paragraphs .49 through .66).

.71 When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph(s) the reasons why his audit did not comply with generally accepted auditing standards. He should state that the scope of his audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, he should also disclose any other reservations he has regarding fair presentation in conformity with generally accepted accounting principles.

.72 An example of a report disclaiming an opinion resulting from an inability to obtain sufficient competent evidential matter because of the scope limitation follows:

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<sup>23</sup> If an accountant is engaged to conduct an audit of the financial statements of a nonpublic entity in accordance with generally accepted auditing standards, but is requested to change the engagement to a review or a compilation of the statements, he should look to guidance in the Statement on Standards for Accounting and Review Services 1, paragraphs 44—49 [AR section 100.44—.49]. (See section 504, *Association With Financial Statements*.)

### Independent Auditor's Report

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.<sup>24</sup>

[Second paragraph of standard report should be omitted]

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at \$\_\_\_\_\_ as of December 31, 19X2, and at \$\_\_\_\_\_ as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

## Piecemeal Opinions

.73 Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) should not be expressed when the auditor has disclaimed an opinion or has expressed an adverse opinion on the financial statements *taken as a whole* because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion.

## Reports on Comparative Financial Statements

.74 The fourth standard of reporting requires that an auditor's report contain either an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor<sup>25</sup> should update<sup>26</sup> his report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of

<sup>24</sup> The wording in the first paragraph of the auditor's standard report is changed in a disclaimer of opinion because of a scope limitation. The first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with generally accepted auditing standards. In addition, the last sentence of the first paragraph is also deleted, because of the scope limitation, to eliminate the reference to the auditor's responsibility to express an opinion.

<sup>25</sup> A *continuing auditor* is one who has audited the financial statements of the current period and of one or more consecutive periods immediately prior to the current period.

If one firm of independent auditors merges with another firm and the new firm becomes the auditor of a former client of one of the former firms, the new firm may accept responsibility and express an opinion on the financial statements for the prior period(s), as well as for those of the current period. In such circumstances, the new firm should follow the guidance in paragraphs .74 through .78 and may indicate in its report or signature that a merger took place and may name the firm of independent auditors that was merged with it. If the new firm decides not to express an opinion on the prior-period financial statements, the guidance in paragraphs .79 through .83 should be followed.

<sup>26</sup> An updated report on prior-period financial statements should be distinguished from a reissuance of a previous report (see section 530, *Dating of the Independent Auditor's Report*, paragraphs .06 through .08), since in issuing an updated report the continuing auditor considers information that he has become aware of during his audit of the current-period financial statements (see paragraph .77) and because an updated report is issued in conjunction with the auditor's report on the current-period financial statements.



the current period.<sup>27</sup> Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of his most recent audit. (See section 530, *Dating of the Independent Auditor's Report*, paragraph .01.)

.75 During his audit of the current-period financial statements, the auditor should be alert for circumstances or events that affect the prior-period financial statements presented (see paragraph .77) or the adequacy of informative disclosures concerning those statements. (See section 431, *Adequacy of Disclosure in Financial Statements*, and ARB No. 43, Chapter 2A [AC section F43].) In updating his report on the prior-period financial statements, the auditor should consider the effects of any such circumstances or events coming to his attention.

### **Different Reports on Comparative Financial Statements Presented**

.76 Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements (excluding the standard introductory and scope paragraphs, where applicable) with different reports on one or more financial statements presented.

#### **Standard Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements**

##### Independent Auditor's Report

[Same first and second paragraphs as the standard report ]

The Company has excluded, from property and debt in the accompanying 19X2 balance sheet, certain lease obligations that were entered into in 19X2 which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$\_\_\_\_\_, long-term debt by \$\_\_\_\_\_, and retained earnings by \$\_\_\_\_\_ as of December 31, 19X2, and net income and earnings per share would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively, for the year then ended.

In our opinion, except for the effects on the 19X2 financial statements of not capitalizing certain lease obligations as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

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<sup>27</sup> A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units and not-for-profit organizations frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund, or the auditor would need to modify his report.

## Standard Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows

### Independent Auditor's Report

*[Same first paragraph as the standard report]*

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 19X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 19X0, enter into the determination of net income and cash flows for the year ended December 31, 19X1.<sup>28</sup>

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 19X1.

In our opinion, the balance sheets of ABC Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 19X2, present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

## Opinion on Prior-Period Financial Statements Different From the Opinion Previously Expressed

.77 If, during his current audit, an auditor becomes aware of circumstances or events that affect the financial statements of a prior period, he should consider such matters when updating his report on the financial statements of the prior period. For example, if an auditor has previously qualified his opinion or expressed an adverse opinion on financial statements of a prior period because of a departure from generally accepted accounting principles, and the prior-period financial statements are restated in the current period to conform with generally accepted accounting principles, the auditor's updated report on the financial statements of the prior period should indicate that the statements have been restated and should express an unqualified opinion with respect to the restated financial statements.

.78 If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate explanatory paragraph(s) preceding the opinion paragraph of his report.<sup>29</sup> The explanatory paragraph(s) should disclose (a) the date of the

<sup>28</sup> It is assumed that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles. See section 420, *Consistency of Application of Generally Accepted Accounting Principles*, for a discussion of consistency.

<sup>29</sup> With the elimination of the *subject to* opinion qualification for uncertainties (see footnote 13), a separate explanatory paragraph (as described above) that discusses the resolution of an

auditor's previous report, (b) the type of opinion previously expressed, (c) the circumstances or events that caused the auditor to express a different opinion, and (d) that the auditor's updated opinion on the financial statements of the prior period is different from his previous opinion on those statements. The following is an example of an explanatory paragraph that may be appropriate when an auditor issues an updated report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed:

Independent Auditor's Report

*[Same first and second paragraphs as the standard report]*

In our report dated March 1, 19X2, we expressed an opinion that the 19X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 19X1 financial statements to conform with generally accepted accounting principles. Accordingly, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.<sup>30</sup>

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

## Report of Predecessor Auditor

.79 A predecessor auditor ordinarily would be in a position to reissue his report on the financial statements of a prior period at the request of a former client if he is able to make satisfactory arrangements with his former client to perform this service and if he performs the procedures described in paragraph .80.<sup>31</sup>

## Predecessor Auditor's Report Reissued

.80 Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period, a predecessor auditor should consider whether his previous report on those statements is still appropriate. Either the current form or manner of presentation of the financial statements of the prior period or one or more subsequent events might make a predecessor auditor's previous report inappropriate. Consequently, a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements that he reported on with the financial statements to be presented for comparative purposes, and (c) obtain a letter of representations from the successor auditor. The letter of representations should state whether the successor's audit revealed any mat-

(Footnote Continued)

uncertainty described in an explanatory paragraph of the previously-issued report is no longer necessary since the latter did not result in a qualified opinion. A separate explanatory paragraph is required only when the current updated opinion is different from the opinion in the immediately preceding report issued.

<sup>30</sup> See footnote 20.

<sup>31</sup> It is recognized that there may be reasons why a predecessor auditor's report may not be reissued and this section does not address the various situations that could arise.

ters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor. Also, the predecessor auditor may wish to consider the matters described in section 543, *Part of Examination Made by Other Independent Auditors*, paragraphs .10 through .12. However, the predecessor auditor should not refer in his reissued report to the report or work of the successor auditor.

**.81** A predecessor auditor who has agreed to reissue his report may become aware of events or transactions occurring subsequent to the date of his previous report on the financial statements of a prior period that may affect his previous report (for example, the successor auditor might indicate in his response that certain matters have had a material effect on the prior-period financial statements reported on by the predecessor auditor). In such circumstances, the predecessor auditor should make inquiries and perform other procedures that he considers necessary (for example, reviewing the working papers of the successor auditor as they relate to the matters affecting the prior-period financial statements). He should then decide, on the basis of the evidential matter obtained, whether to revise his report. If a predecessor auditor concludes that his report should be revised, he should follow the guidance in paragraphs .77, .78, and .82 of this section.

**.82** A predecessor auditor's knowledge of the current affairs of his former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing his report on prior-period financial statements, a predecessor auditor should use the date of his previous report to avoid any implication that he has examined any records, transactions, or events after that date. If the predecessor auditor revises his report or if the financial statements are restated, he should dual-date his report. (See section 530, *Dating of the Independent Auditor's Report*, paragraph .05.)

### Predecessor Auditor's Report Not Presented

**.83** If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the introductory paragraph of his report (a) that the financial statements of the prior period were audited by another auditor,<sup>32</sup> (b) the date of his report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than a standard report, the substantive reasons therefor. An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

#### Independent Auditor's Report

We have audited the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

[Same second paragraph as the standard report]

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

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<sup>32</sup> The successor auditor should not name the predecessor auditor in his report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with, that of the successor auditor.

If the predecessor auditor's report was other than a standard report, the successor auditor should describe the nature of and reasons for the explanatory paragraph added to the predecessor's report or his opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

... were audited by other auditors whose report dated March 1, 19X2, on those statements included an explanatory paragraph that described the litigation discussed in Note X to the financial statements.

If the financial statements have been restated, the introductory paragraph should indicate that a predecessor auditor reported on the financial statements of the prior period before restatement. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself as to the appropriateness of the restatement adjustments, he may also include the following paragraph in his report:

We also audited the adjustments described in Note X that were applied to restate the 19X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

[As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

## Effective Date and Transition

**.84** This section is effective for reports issued or reissued on or after January 1, 1989. Earlier application of the provisions of this section is permissible.

**.85** An auditor who expressed an opinion qualified *subject to* the effect of an uncertainty on prior-period financial statements should consider the status of the uncertainty in determining his reporting responsibilities under the reporting provisions of this section. If the uncertainty has been resolved in the current period, no mention of the uncertainty (or of the opinion qualification of the prior-period financial statements) is required in the auditor's report.<sup>33</sup> If, however, the uncertainty still exists in the current period, the auditor should include an explanatory paragraph in his report because of the uncertainty as discussed in paragraphs .31 through .33.

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[The next page is 681.]

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<sup>33</sup> The auditor should, however, consider the adequacy of the disclosure regarding the resolution of the uncertainty in the company's financial statements.

**AU Section 9508*****Reports on Audited Financial Statements:  
Auditing Interpretations of Section 508*****1. Report of an Outside Inventory-Taking Firm as an Alternative Procedure for Observing Inventories**

**.01 Question**—Section 508, *Reports on Audited Financial Statements*, paragraph .42 states that “Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . .” A footnote to that paragraph states: “Circumstances such as the timing of his work may make it impossible for the auditor to accomplish these procedures. In this case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not include reference to the omission of the procedures or to the use of alternative procedures.” Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor’s own observation of physical inventories?

**.02 Interpretation**—Sufficient competent evidential matter for inventories is discussed in section 331, *Inventories*, paragraphs .09—.12. Section 331.09 states that “. . . it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client’s representations about the quantities and physical condition of the inventories.”

**.03 Section 331.10—.11** discusses two variations of that procedure when the client has well-kept perpetual records that are checked periodically by comparisons with physical counts or when the client uses statistical sampling to determine inventories. In such instances, the auditor may vary the timing and extent of his observation of physical counts, but he “must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used.”

**.04 Section 331.12** deals with circumstances in which the auditor has not satisfied himself as to inventories in the possession of the client through procedures described in section 331.09—.11. In those circumstances, the general requirement for satisfactory alternative procedures is that “. . . tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions.”

**.05** The fact that the inventory is counted by an outside inventory firm of nonaccountants is not, by itself, a satisfactory substitute for the auditor’s own observation or taking of some physical counts. The auditor’s concern, in this

respect, is to satisfy himself as to the effectiveness of the counting procedures used. If the client engages an outside inventory firm to take the physical inventory, the auditor's primary concern would be to evaluate the effectiveness of the procedures used by the outside firm and his auditing procedures would be applied accordingly.

.06 Thus, the auditor would examine the outside firm's program, observe its procedures and controls, make or observe some physical counts of the inventory, recompute calculations of the submitted inventory on a test basis and apply appropriate tests to the intervening transactions. The independent auditor ordinarily may reduce the extent of his work on the physical count of inventory because of the work of an outside inventory firm, but any restriction on the auditor's judgment concerning the extent of his contact with the inventory would be a scope restriction.

[Issue Date: July, 1975.]

## **[2.] Reporting on Comparative Financial Statements of Nonprofit Organizations**

[.07—.10] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977.]

## **[3.] Reporting on Loss Contingencies**

[.11—.14] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

## **[4.] Reports on Consolidated Financial Statements That Include Supplementary Consolidating Information**

[.15—.20] [Superseded December 31, 1980, by SAS No. 29.] (See section 551.)

## **[5.] Disclosures of Subsequent Events**

[.21—.24] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

## **[6.] The Materiality of Uncertainties**

[.25—.28] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

## **[7.] Reporting on an Uncertainty**

[.29—.32] [Withdrawn August, 1982 by Statement on Auditing Standards No. 43.]

## **8. Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting**

.33 *Question*—APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, states that if liquidation of an entity appears imminent, financial information may be prepared on the assumption that liquidation will occur. How should the auditor report on financial statements that are prepared on a liquidation basis of accounting for an entity in liquidation or for which liquidation appears imminent?

**.34 Answer**—A liquidation basis of accounting may be considered generally accepted accounting principles for entities in liquidation or for which liquidation appears imminent. Therefore, the auditor should issue an unqualified opinion on such financial statements, provided that the liquidation basis of accounting has been properly applied, and that adequate disclosures are made in the financial statements.

**.35** Typically, the financial statements of entities that adopt a liquidation basis of accounting are presented along with financial statements of a period prior to adoption of a liquidation basis that were prepared on the basis of generally accepted accounting principles for going concerns. In such circumstances, the auditor's report ordinarily should include an explanatory paragraph that states that the entity has changed the basis of accounting used to determine the amounts at which assets and liabilities are carried from the going concern basis to a liquidation basis.

**.36** Examples of auditor's reports with such an explanatory paragraph follow.

*Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis*

"We have audited the statement of net assets in liquidation of XYZ Company as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 19X2 to April 25, 19X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

"We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of the other auditors provides a reasonable basis for our opinion.

"As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

"In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of XYZ Company as of December 31, 19X2, the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, and the results of its operations and its cash flows for the period from January 1, 19X2 to April 25, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the preceding paragraph."

*Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis*

"We have audited the balance sheet of XYZ Company as of December 31, 19X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and



cash flows for the period from January 1, 19X2 to April 25, 19X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

"We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

"As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

"In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 19X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 19X2 to April 25, 19X2, its net assets in liquidation as of December 31, 19X2, and the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the preceding paragraph."

.37 The auditor may, in subsequent years, continue to include an explanatory paragraph in his report to emphasize that the financial statements are presented on a liquidation basis of accounting.

.38 Sometimes financial statements presented on a liquidation basis are affected by significant uncertainties with respect to the realizability of amounts at which assets are presented and the amounts that creditors will agree to accept in settlement of the obligations due them. In such circumstances, the auditor should consider the need to add an explanatory paragraph (following the opinion paragraph) to his report because of the uncertainty as discussed in section 508.16—.33. Following is an example of an appropriate explanatory paragraph.

"As discussed in Note X to the financial statements, it is not presently determinable whether the amounts realizable from the disposition of the remaining assets or the amounts that creditors agree to accept in settlement of the obligations due them will differ materially from the amounts shown in the accompanying financial statements."

[Issue Date: December, 1984.]

## **[9.] Quantifying Departures From Generally Accepted Accounting Principles**

[.39—.43] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

**[10.] Updated Reports Resulting From the Retroactive Suspension of Earnings per Share and Segment Information Disclosure Requirements**

[.44—.48] [Withdrawn March, 1989 by the Auditing Standards Board.]

**11. Restating Financial Statements Reported on by a Predecessor Auditor**

[.49—.50] [An Interpretation of section 315, *Communications Between Predecessor and Successor Auditors*, and section 508, *Reports on Audited Financial Statements*, paragraph entitled *Restating Financial Statements Reported on by a Predecessor Auditor*, can be found in section 9315.06—.07.]

**12. Reference in Auditor's Standard Report to Management's Report**

**.51 Question**—One of the basic elements of the auditor's standard report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

**.52 Interpretation**—No. The statement about management's responsibilities for the financial statements required by section 508, *Reports on Audited Financial Statements*, should not be further elaborated upon in the auditor's standard report or referenced to management's report. Such modifications to the standard auditor's report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

[Issue Date: January, 1989.]

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[The next page is 771.]

## AU Section 530

### ***Dating of the Independent Auditor's Report***

Sources: SAS No. 1, section 530; SAS No. 29.

Issue date, unless otherwise indicated: November, 1972.

.01 Generally, the date of completion of the field work should be used as the date of the independent auditor's report. Paragraph .05 describes the procedure to be followed when a subsequent event occurring after the completion of the field work is disclosed in the financial statements.

.02 The auditor has no responsibility to make any inquiry or carry out any auditing procedures for the period after the date of his report.<sup>1</sup> However, with respect to filings under the Securities Act of 1933, reference should be made to section 711.10—13.\*

### **Events Occurring After Completion of Field Work But Before Issuance of Report**

.03 In case a subsequent event of the type requiring adjustment of the financial statements (as discussed in section 560.03) occurs after the date of the independent auditor's report but before its issuance, and the event comes to the attention of the auditor, the financial statements should be adjusted or the auditor should qualify his opinion.<sup>2</sup> When the adjustment is made without disclosure of the event, the report ordinarily should be dated in accordance with paragraph .01. However, if the financial statements are adjusted and disclosure of the event is made, or if no adjustment is made and the auditor qualifies his opinion,<sup>3</sup> the procedures set forth in paragraph .05 should be followed.

.04 In case a subsequent event of the type requiring disclosure (as discussed in section 560.05) occurs after the date of the auditor's report but before issuance of his report, and the event comes to the attention of the auditor, it should be disclosed in a note to the financial statements or the auditor should qualify his opinion.<sup>4</sup> If disclosure of the event is made, either in a note or in the auditor's report, the auditor would date his report as set forth in the following paragraph.

.05 The independent auditor has two methods available for dating his report when a subsequent event disclosed in the financial statements occurs after completion of his field work but before issuance of his report. He may use "dual dating," for example, "February 16, 19 , except for Note , as to which the date is March 1, 19 ," or he may date his report as of the later

<sup>1</sup> See section 561 regarding procedures to be followed by the auditor who, subsequent to the date of his report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts.

<sup>2</sup> Reference changed by issuance of Statement on Auditing Standards No. 37.

<sup>3</sup> In some cases, a disclaimer of opinion or an adverse opinion may be appropriate.

<sup>4</sup> Ibid.

<sup>5</sup> Ibid.

date. In the former instance, his responsibility for events occurring subsequent to the completion of his field work is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the date of his report and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

## **Reissuance of the Independent Auditor's Report**

**.06** An independent auditor may reissue his report on financial statements contained in annual reports filed with the Securities and Exchange Commission or other regulatory agencies or in a document he submits to his client or to others that contains information in addition to the client's basic financial statements subsequent to the date of his original report on the basic financial statements. An independent auditor may also be requested by his client to furnish additional copies of a previously issued report. Use of the original report date in a reissued report removes any implication that records, transactions, or events after that date have been examined or reviewed. In such cases, the independent auditor has no responsibility to make further investigation or inquiry as to events which may have occurred during the period between the original report date and the date of the release of additional reports. However, see section 711\* as to an auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933 and see section 508.79—82, for the predecessor auditor's responsibility when reissuing or consenting to the reuse of a report previously issued on the financial statements of a prior period. [As modified, effective December 31, 1980, by SAS No. 29.] (See section 551.)

**.07** In some cases, it may not be desirable for the independent auditor to reissue his report in the circumstances described in paragraph .06 because he has become aware of an event that occurred subsequent to the date of his original report that requires adjustment or disclosure in the financial statements. In such cases, adjustment with disclosure or disclosure alone should be made as described in section 560.08. The independent auditor should consider the effect of these matters on his opinion and he should date his report in accordance with the procedures described in paragraph .05.

**.08** However, if an event of the type requiring disclosure only (as discussed in sections 560.05 and 560.08) occurs between the date of the independent auditor's original report and the date of the reissuance of such report, and if the event comes to the attention of the independent auditor, the event may be disclosed in a separate note to the financial statements captioned somewhat as follows:

Event (Unaudited) Subsequent to the Date of the  
Independent Auditor's Report

Under these circumstances, the report of the independent auditor would carry the same date used in the original report.

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[The next page is 801.]

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\* Reference changed by issuance of Statement on Auditing Standards No. 37.

**AU Section 534*****Reporting on Financial  
Statements Prepared for  
Use in Other Countries***

Source: SAS No. 51.

**Effective for audits of financial statements for periods beginning after July 31, 1986, unless otherwise indicated.**

.01 This section provides guidance for an independent auditor practicing in the United States who is engaged to report on the financial statements of a U.S. entity that have been prepared in conformity with accounting principles generally accepted in another country for use outside the United States.<sup>1</sup> A "U.S. entity" is an entity that is either organized or domiciled in the United States.

**Purpose and Use of Financial Statements**

.02 A U.S. entity ordinarily prepares financial statements for use in the United States in conformity with accounting principles generally accepted in the United States, but it may also prepare financial statements that are intended for use outside the United States and are prepared in conformity with accounting principles generally accepted in another country. For example, the financial statements of a U.S. entity may be prepared for inclusion in the consolidated financial statements of a non-U.S. parent. A U.S. entity may also have non-U.S. investors or may decide to raise capital in another country. Before reporting on financial statements prepared in conformity with the accounting principles of another country, the auditor should have a clear understanding of, and obtain written representations from management regarding, the purpose and uses of such financial statements. If the auditor uses the standard report of another country, and the financial statements will have general distribution in that country, he should consider whether any additional legal responsibilities are involved.

**General and Fieldwork Standards**

.03 When auditing the financial statements of a U.S. entity prepared in conformity with accounting principles generally accepted in another country, the auditor should perform the procedures that are necessary to comply with the general and fieldwork standards of U.S. generally accepted auditing standards (GAAS).

.04 The auditing procedures generally performed under U.S. GAAS may need to be modified, however. The assertions embodied in financial statements prepared in conformity with accounting principles generally accepted in another country may differ from those prepared in conformity with U.S.

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<sup>1</sup> See paragraph .07, however, for a discussion of financial statements prepared in conformity with accounting principles generally accepted in another country for limited distribution in the United States.

generally accepted accounting principles. For example, accounting principles generally accepted in another country may require that certain assets be revalued to adjust for the effects of inflation—in which case, the auditor should perform procedures to test the revaluation adjustments. On the other hand, another country's accounting principles may not require or permit recognition of deferred taxes; consequently, procedures for testing deferred tax balances would not be applicable. As another example, the accounting principles of some countries do not require or permit disclosure of related party transactions. Determining that such transactions are properly disclosed, therefore, would not be an audit objective in such cases. Other objectives, however, would remain relevant—such as identifying related parties in order to fully understand the business purpose, nature, and extent of the transactions and their effects on the financial statements.

**.05** The auditor should understand the accounting principles generally accepted in the other country. Such knowledge may be obtained by reading the statutes or professional literature (or codifications thereof) that establish or describe the accounting principles generally accepted in the other country. Application of accounting principles to a particular situation often requires practical experience; the auditor should consider, therefore, consulting with persons having such expertise in the accounting principles of the other country. If the accounting principles of another country are not established with sufficient authority or by general acceptance, or a broad range of practices is acceptable, the auditor may nevertheless be able to report on financial statements for use in such countries if, in the auditor's judgment, the client's principles and practices are appropriate in the circumstances and are disclosed in a clear and comprehensive manner. In determining the appropriateness of the accounting principles used, the auditor may consider, for example, International Accounting Standards established by the International Accounting Standards Committee.

## **Compliance With Auditing Standards of Another Country**

**.06** In those circumstances in which the auditor is requested to apply the auditing standards of another country when reporting on financial statements prepared in conformity with accounting principles generally accepted in that country, the auditor should comply with the general and fieldwork standards of that country as well as with those standards in U.S. GAAS. This may require the auditor to perform certain procedures required by auditing standards of the other country in addition to those required by U.S. GAAS. The auditor will need to read the statutes or professional literature, or codifications thereof, that establish or describe the auditing standards generally accepted in the other country. He should understand, however, that such statutes or professional literature may not be a complete description of auditing practices and, therefore, should consider consulting with persons having expertise in the auditing standards of the other country.

## **Reporting Standards**

**.07** If financial statements prepared in conformity with accounting principles generally accepted in another country are prepared for use only outside the United States, the auditor may report using either (a) a U.S.-style report modified to report on the accounting principles of another country (see paragraphs .09 and .10) or (b) if appropriate, the report form of the other country (see paragraphs .11 and .12). This is not intended to preclude limited distribution of the financial statements to parties (such as banks, institutional

investors, and other knowledgeable parties that may choose to rely on the report) within the United States that deal directly with the entity, if the financial statements are to be used in a manner that permits such parties to discuss differences from U.S. accounting and reporting practices and their significance with the entity.

.08 Financial statements prepared in conformity with accounting principles generally accepted in another country ordinarily are not useful to U.S. users. Therefore, if financial statements are needed for use both in another country and within the United States, the auditor may report on two sets of financial statements for the entity—one prepared in conformity with accounting principles generally accepted in another country for use outside the United States, and the other prepared in accordance with accounting principles generally accepted in the United States (see paragraph .13). If dual statements are not prepared, or for some other reason the financial statements prepared in conformity with accounting principles generally accepted in another country will have more than limited distribution in the United States, the auditor should report on them using the U.S. standard form of report, modified as appropriate for departures from accounting principles generally accepted in the United States (see paragraph .14).

### Use Only Outside the United States

.09 A U.S.-style report modified to report on financial statements prepared in conformity with accounting principles generally accepted in another country that are intended for use only outside the United States should—

- a. A title that includes the word “independent.”<sup>2</sup>
- b. A statement that the financial statements identified in the report were audited.
- c. A statement that refers to the note to the financial statements that describes the basis of presentation of the financial statements on which the auditor is reporting, including identification of the nationality of the accounting principles.
- d. A statement that the financial statements are the responsibility of the Company’s management<sup>3</sup> and that the auditor’s responsibility is to express an opinion on the financial statements based on his audit.
- e. A statement that the audit was conducted in accordance with auditing standards generally accepted in the United States (and, if appropriate, with the auditing standards of the other country).
- f. A statement that U.S. standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- g. A statement that an audit includes:
  - (1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,

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<sup>2</sup> This statement does not require a title for an auditor’s report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent. [Footnote added to reflect conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>3</sup> In some instances, a document containing the auditor’s report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor’s report should state that the financial statements are management’s responsibility. [Footnote added to reflect conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

- (2) Assessing the accounting principles used and significant estimates made by management, and
- (3) Evaluating the overall financial statement presentation.<sup>4</sup>
- h. A statement that the auditor believes that his audit provides a reasonable basis for his opinion.
- i. A paragraph that expresses the auditor's opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described. If the auditor concludes that the financial statements are not fairly presented on the basis of accounting described, all substantive reasons for that conclusion should be disclosed in an additional explanatory paragraph (preceding the opinion paragraph) of the report, and the opinion paragraph should include appropriate modifying language as well as a reference to the explanatory paragraph.
- j. If the auditor is auditing comparative financial statements and the described basis of accounting has not been applied in a manner consistent with that of the preceding period and the change has had a material effect on the comparability of the financial statements, the auditor should add an explanatory paragraph to his report (following the opinion paragraph) that describes the change in accounting principle and refers to the note to the financial statements that discusses the change and its effect on the financial statements.
- k. The manual or printed signature of the auditor's firm.
- l. Date.<sup>5</sup>

[Paragraph amended to reflect conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

.10 The following is an illustration of such a report:

#### Independent Auditor's Report

We have audited the accompanying balance sheet of International Company as of December 31, 19XX and the related statements of income, retained earnings, and cash flows for the year then ended which, as described in Note X, have been prepared on the basis of accounting principles accepted in [name of country]. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States (and in [name of country]). U.S. standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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<sup>4</sup> Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, paragraphs .03 and .04, discuss the auditor's evaluation of the overall presentation of the financial statements. [Footnote added to reflect conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>5</sup> For guidance on dating the independent auditor's report, see section 530, *Dating of the Independent Auditor's Report*. [Footnote added to reflect conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]



In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of International Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in [name of country].

[Paragraph amended to reflect conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

.11 The independent auditor may also use the auditor's standard report of another country, provided that—

- a. Such a report would be used by auditors in the other country in similar circumstances.
- b. The auditor understands, and is in a position to make, the attestations contained in such a report (see paragraph .12).

The auditor should consider whether the standard report of another country or the financial statements may be misunderstood because they resemble those prepared in conformity with U.S. standards. When the auditor believes there is a risk of misunderstanding, he should identify the other country in the report.

.12 When the auditor uses the standard report of the other country, the auditor should comply with the reporting standards of that country. The auditor should recognize that the standard report used in another country, even when it appears similar to that used in the United States, may convey a different meaning and entail a different responsibility on the part of the auditor due to custom or culture. Use of a standard report of another country may also require the auditor to provide explicit or implicit assurance of statutory compliance or otherwise require understanding of local law. When using the auditor's standard report of another country, the auditor needs to understand applicable legal responsibilities, in addition to the auditing standards and the accounting principles generally accepted in the other country. Accordingly, depending on the nature and extent of the auditor's knowledge and experience, he should consider consulting with persons having expertise in the audit reporting practices of the other country to attain the understanding needed to issue that country's standard report.

.13 A U.S. entity that prepares financial statements in conformity with U.S. generally accepted accounting principles also may prepare financial statements in conformity with accounting principles generally accepted in another country for use outside the United States. In such circumstances, the auditor may report on the financial statements that are in conformity with accounting principles of the other country by following the guidance in paragraphs .09 and .10. The auditor may wish to include, in one or both of the reports, a statement that another report has been issued on the financial statements for the entity that have been prepared in accordance with accounting principles generally accepted in another country. The auditor may also wish to reference any note describing significant differences between the accounting principles used and U.S. GAAP. An example of such a statement follows.

We also have reported separately on the financial statements of International Company for the same period presented in accordance with accounting principles generally accepted in [name of country]. (The significant differences between the accounting principles accepted in [name of country] and those generally accepted in the United States are summarized in Note X.)

### Use in the United States

.14 If the auditor is requested to report on the fair presentation of financial statements, prepared in conformity with the accounting principles generally accepted in another country, that will have more than limited distribution in the United States, he should use the U.S. standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph .08), modified as appropriate (see section 508.49—.66), because of departures from accounting principles generally accepted in the United States.<sup>6</sup> The auditor may also, in a separate paragraph to the report, express an opinion on whether the financial statements are presented in conformity with accounting principles generally accepted in another country.

.15 The auditor may also report on the same set of financial statements, prepared in conformity with accounting principles generally accepted in another country, that will have more than limited distribution in the United States by using both the standard report of the other country or a U.S.-style report (described in paragraph .09) for distribution outside the United States, and a U.S. form of report (described in paragraph .14) for distribution in the United States.

### Effective Date

.16 This section is effective for audits of financial statements for periods beginning after July 31, 1986.

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[The next page is 841.]

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<sup>6</sup> This section does not apply to reports on financial statements of U.S. subsidiaries of foreign registrants presented in SEC filings of foreign parent companies where the subsidiaries' financial statements have been prepared on the basis of accounting principles used by the parent company. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

## AU Section 543

### ***Part of Audit Performed by Other Independent Auditors***

Source: SAS No. 1, section 543; SAS No. 64.

See section 9543 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 This section provides guidance on the professional judgments the independent auditor makes in deciding (a) whether he may serve as principal auditor and use the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented and (b) the form and content of the principal auditor's report in these circumstances.<sup>1</sup> Nothing in this section should be construed to require or imply that an auditor, in deciding whether he may properly serve as principal auditor without himself auditing particular subsidiaries, divisions, branches, components, or investments of his client, should make that decision on any basis other than his judgment regarding the professional considerations as discussed in paragraphs .02 and .10; nor should an auditor state or imply that a report that makes reference to another auditor is inferior in professional standing to a report without such a reference. [As modified, September 1981, by the Auditing Standards Board.]

#### **Principal Auditor's Course of Action**

.02 The auditor considering whether he may serve as principal auditor may have performed all but a relatively minor portion of the work, or significant parts of the audit may have been performed by other auditors. In the latter case, he must decide whether his own participation is sufficient to enable him to serve as the principal auditor and to report as such on the financial statements. In deciding this question, the auditor should consider, among other things, the materiality of the portion of the financial statements he has audited in comparison with the portion audited by other auditors, the extent of his knowledge of the overall financial statements, and the importance of the components he audited in relation to the enterprise as a whole. [As modified, September 1981, by the Auditing Standards Board.]

.03 If the auditor decides that it is appropriate for him to serve as the principal auditor, he must then decide whether to make reference in his report<sup>2</sup> to the audit performed by another auditor. If the principal auditor decides to assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, no reference should be made to the other auditor's work or report. On the other hand, if the principal auditor

<sup>1</sup> Section 315 applies if an auditor uses the work of a predecessor auditor in expressing an opinion on financial statements.

<sup>2</sup> See paragraph .09 for example of appropriate reporting when reference is made to the audit of other auditors.

decides not to assume that responsibility, his report should make reference to the audit of the other auditor and should indicate clearly the division of responsibility between himself and the other auditor in expressing his opinion on the financial statements. Regardless of the principal auditor's decision, the other auditor remains responsible for the performance of his own work and for his own report.

### **Decision Not to Make Reference**

.04 If the principal auditor is able to satisfy himself as to the independence and professional reputation of the other auditor (see paragraph .10) and takes steps he considers appropriate to satisfy himself as to the audit performed by the other auditor (see paragraph .12), he may be able to express an opinion on the financial statements taken as a whole without making reference in his report to the audit of the other auditor. If the principal auditor decides to take this position, he should not state in his report that part of the audit was made by another auditor because to do so may cause a reader to misinterpret the degree of responsibility being assumed.

.05 Ordinarily, the principal auditor would be able to adopt this position when:

- a. Part of the audit is performed by another independent auditor which is an associated or correspondent firm and whose work is acceptable to the principal auditor based on his knowledge of the professional standards and competence of that firm; or
- b. The other auditor was retained by the principal auditor and the work was performed under the principal auditor's guidance and control; or
- c. The principal auditor, whether or not he selected the other auditor, nevertheless takes steps he considers necessary to satisfy himself as to the audit performed by the other auditor and accordingly is satisfied as to the reasonableness of the accounts for the purpose of inclusion in the financial statements on which he is expressing his opinion; or
- d. The portion of the financial statements audited by the other auditor is not material to the financial statements covered by the principal auditor's opinion.

### **Decision to Make Reference**

.06 On the other hand, the principal auditor may decide to make reference to the audit of the other auditor when he expresses his opinion on the financial statements. In some situations, it may be impracticable for the principal auditor to review the other auditor's work or to use other procedures which in the judgment of the principal auditor would be necessary for him to satisfy himself as to the audit performed by the other auditor. Also, if the financial statements of a component audited by another auditor are material in relation to the total, the principal auditor may decide, regardless of any other considerations, to make reference in his report to the audit of the other auditor.

.07 When the principal auditor decides that he will make reference to the audit of the other auditor, his report should indicate clearly, in both the introductory, scope and opinion paragraphs, the division of responsibility as between that portion of the financial statements covered by his own audit and that covered by the audit of the other auditor. The report should disclose the

magnitude of the portion of the financial statements audited by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements audited by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor.<sup>3</sup>

**.08** Reference in the report of the principal auditor to the fact that part of the audit was made by another auditor is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors who conducted the audits of various components of the overall financial statements. [As modified, September 1981, by the Auditing Standards Board.]

**.09** An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the audit of the other auditor follows:

#### Independent Auditor's Report

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 19....., and the related consolidated statements of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of the other auditors provides a reasonable basis for our opinion.

In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19....., and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

When two or more auditors in addition to the principal auditor participate in the audit, the percentages covered by the other auditors may be stated in the aggregate. [Paragraph amended to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

### **Procedures Applicable to Both Methods of Reporting**

**.10** Whether or not the principal auditor decides to make reference to the audit of the other auditor, he should make inquiries concerning the professional reputation and independence of the other auditor. He also should adopt

<sup>3</sup> As to filings with the Securities and Exchange Commission, see Rule 2-05 of Regulation S-X.

appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements. These inquiries and other measures may include procedures such as the following:

- a. Make inquiries as to the professional reputation and standing of the other auditor to one or more of the following:
  - (i) The American Institute of Certified Public Accountants,<sup>4</sup> the applicable state society of certified public accountants and/or the local chapter, or in the case of a foreign auditor, his corresponding professional organization.
  - (ii) Other practitioners.
  - (iii) Bankers and other credit grantors.
  - (iv) Other appropriate sources.
- b. Obtain a representation from the other auditor that he is independent under the requirements of the American Institute of Certified Public Accountants and, if appropriate, the requirements of the Securities and Exchange Commission.
- c. Ascertain through communication with the other auditor:
  - (i) That he is aware that the financial statements of the component which he is to audit are to be included in the financial statements on which the principal auditor will report and that the other auditor's report thereon will be relied upon (and, where applicable, referred to) by the principal auditor.
  - (ii) That he is familiar with accounting principles generally accepted in the United States and with the generally accepted auditing standards promulgated by the American Institute of Certified Public Accountants and will conduct his audit and will report in accordance therewith.
  - (iii) That he has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies such as the Securities and Exchange Commission, if appropriate.
  - (iv) That a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

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<sup>4</sup> The AICPA Professional Ethics Division can respond to inquiries about whether individuals are members of the American Institute of Certified Public Accountants and whether complaints against members have been adjudicated by the Joint Trial Board. The division cannot respond to inquiries about public accounting firms or provide information about letters of required corrective action issued by the division or pending disciplinary proceedings or investigations. The AICPA Division for CPA Firms can respond to inquiries about whether specific public accounting firms are members of either the Private Companies Practice Section (PCPS) or the SEC Practice Section (SECPS), and can indicate whether a firm had a peer review in compliance with the Section's membership requirements and whether any sanctions against the firm have been publicly announced. In addition, the division will supply copies of peer-review reports that have been accepted by the applicable section of the division and information submitted by member firms on applications for membership and annual updates. The AICPA Quality Review Division or the appropriate state society can respond to inquiries as to whether specific public accounting firms are members of the AICPA Quality Review program and can indicate whether a firm had a quality review in compliance with the *AICPA Standards for Performing and Reporting on Quality Reviews* [QR section 100]. [Footnote amended by the Auditing Standards Board, June 1990.]

(Inquiries as to matters under a, and c (ii) and (iii) ordinarily would be unnecessary if the principal auditor already knows the professional reputation and standing of the other auditor and if the other auditor's primary place of practice is in the United States.)

[As modified, September 1981, by the Auditing Standards Board.]

.11 If the results of inquiries and procedures by the principal auditor with respect to matters described in paragraph .10 lead him to the conclusion that he can neither assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, nor report in the manner set forth in paragraph .09, he should appropriately qualify his opinion or disclaim an opinion on the financial statements taken as a whole. His reasons therefor should be stated, and the magnitude of the portion of the financial statements to which his qualification extends should be disclosed.

## **Additional Procedures Under Decision Not to Make Reference**

.12 When the principal auditor decides not to make reference to the audit of the other auditor, in addition to satisfying himself as to the matters described in paragraph .10, he should also consider whether to perform one or more of the following procedures:

- a. Visit the other auditor and discuss the audit procedures followed and results thereof.
- b. Review the audit programs of the other auditor. In some cases, it may be appropriate to issue instructions to the other auditor as to the scope of his audit work.
- c. Review the working papers of the other auditor, including the understanding of the internal control structure and the assessment of control risk.

.13 In some circumstances the principal auditor may consider it appropriate to participate in discussions regarding the accounts with management personnel of the component whose financial statements are being audited by other auditors and/or to make supplemental tests of such accounts. The determination of the extent of additional procedures, if any, to be applied rests with the principal auditor alone in the exercise of his professional judgment and in no way constitutes a reflection on the adequacy of the other auditor's work. Because the principal auditor in this case assumes responsibility for his opinion on the financial statements on which he is reporting without making reference to the audit performed by the other auditor, his judgment must govern as to the extent of procedures to be undertaken.

## **Long-Term Investments**

.14 With respect to investments accounted for under the equity method, the auditor who uses another auditor's report for the purpose of reporting on the investor's equity in underlying net assets and its share of earnings or losses and other transactions of the investee is in the position of a principal auditor using the work and reports of other auditors. Under these circumstances, the auditor may decide that it would be appropriate to refer to the work and report of the other auditor in his report on the financial statements of the investor. (See paragraphs .06—.11.) When the work and reports of other auditors constitute a major element of evidence with respect to investments

accounted for under the cost method, the auditor may be in a position analogous to that of a principal auditor.

### **Other Auditor's Report Departs From Standard Report**

.15 If the report of the other auditor is other than a standard report, the principal auditor should decide whether the reason for the departure from the standard report is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require recognition in his own report. If the reason for the departure is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to such departure, if the other auditor's report is presented, the principal auditor may wish to make reference to such departure and its disposition.

### **Restated Financial Statements of Prior Years Following a Pooling of Interests**

.16 Following a pooling-of-interests transaction, an auditor may be asked to report on restated financial statements for one or more prior years when other auditors have audited one or more of the entities included in such financial statements. In some of these situations the auditor may decide that he has not audited a sufficient portion of the financial statements for such prior year or years to enable him to serve as principal auditor (see paragraph .02). Also, in such cases, it often is not possible or it may not be appropriate or necessary for the auditor to satisfy himself with respect to the restated financial statements. In these circumstances it may be appropriate for him to express his opinion solely with respect to the combining of such statements; however, no opinion should be expressed unless the auditor has audited the statements of at least one of the entities included in the restatement for at least the latest period presented. The following is an illustration of appropriate reporting on such combination that can be presented in an additional paragraph of the auditor's report following the standard introductory, scope and opinion paragraphs covering the consolidated financial statements for the current year:\*

We previously audited and reported on the consolidated statements of income and cash flows of XYZ Company and subsidiaries for the year ended December 31, 19X1, prior to their restatement for the 19X2 pooling of interests. The contribution of XYZ Company and subsidiaries to revenues and net income represented . . . . . percent and . . . . . percent of the respective restated totals. Separate financial statements of the other companies included in the 19X1 restated consolidated statements of income and cash flows were audited and reported on separately by other auditors. We also audited the combination of the accompanying consolidated statements of income and cash flows for the year ended December 31, 19X1, after restatement for the 19X2 pooling of interests; in our opinion, such consolidated statements have been properly combined on the basis described in Note A of notes to consolidated financial statements.

[As modified, October 1980, by the Auditing Standards Board. As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

.17 In reporting on restated financial statements as described in the preceding paragraph, the auditor does not assume responsibility for the work

\* If restated consolidated balance sheets are also presented, the auditor may also express his opinion with respect to the combination of the consolidated balance sheets.



of other auditors nor the responsibility for expressing an opinion on the restated financial statements taken as a whole. He should apply procedures which will enable him to express an opinion only as to proper combination of the financial statements. These procedures include testing the combination for clerical accuracy and the methods used to combine the restated financial statements for conformity with generally accepted accounting principles. For example, the auditor should make inquiries and apply procedures regarding such matters as the following:

- a. Elimination of intercompany transactions and accounts.
- b. Combining adjustments and reclassifications.
- c. Adjustments to treat like items in a comparable manner, if appropriate.
- d. The manner and extent of presentation of disclosure matters in the restated financial statements and notes thereto.

The auditor should also consider the application of procedures contained in paragraph .10.

[As modified, October 1980, by the Auditing Standards Board.]

### **Predecessor Auditor**

[.18] [Superseded by Statement on Auditing Standards No. 7, effective November 30, 1975.] (See section 315.)

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[The next page is 851.]

**AU Section 9543*****Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*****1. Specific Procedures Performed by the Other Auditor at the Principal Auditor's Request**

**.01 Question**—An independent auditor is auditing the financial statements of a component<sup>1</sup> in accordance with generally accepted auditing standards and is issuing a report to his client that will also be used by another independent auditor who is acting as a principal auditor.<sup>2</sup> The principal auditor requests the other auditor to perform specific procedures, for example, to furnish or test amounts to be eliminated in consolidation, such as intercompany profits, or to read other information in documents containing audited financial statements. In those circumstances, who is responsible to determine the extent of the procedures to be performed?

**.02 Interpretation**—Section 543, *Part of Audit Performed by Other Independent Auditors*, paragraph .10, states that the principal auditor “should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.” Section 543.10c(iv) further states that those measures may include procedures such as ascertaining through communication with the other auditor “that a review will be made of matters affecting elimination of intercompany transactions and accounts.”

**.03** Thus, when the principal auditor requests the other auditor to perform procedures, he should provide specific instructions on procedures to be performed, materiality considerations for that purpose, and other information that may be necessary in the circumstances. The other auditor should perform the requested procedures in accordance with the principal auditor's instructions and, when requested to furnish a written report, should be guided by the provisions of section 622, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*.

[Issue Date: April, 1979.]

**2. Inquiries of the Principal Auditor by the Other Auditor**

**.04 Question**—Section 543, *Part of Audit Performed by Other Independent Auditors*, gives guidance to a principal auditor on making inquiries of the other auditor. Section 543.03 also states that “the other auditor remains responsible for the performance of his own work and for his own report.” Should the other auditor also make inquiries of the principal auditor to fulfill that responsibility?

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<sup>1</sup> For the purposes of this interpretation, the entities whose separate financial statements collectively comprise the consolidated or other financial statements are referred to as components.

<sup>2</sup> See section 543 for the definition of a principal auditor. For the purposes of this interpretation, the auditor whose work is used by a principal auditor is referred to as the other auditor.

**.05 Interpretation**—Section 334, *Related Parties*, states that there may be inquiry of the principal auditor regarding related parties. In addition, before issuing his report, the other auditor should consider whether he should inquire of the principal auditor as to matters that may be significant to his own audit. [Reference changed August, 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 334.)

**.06** The other auditor's consideration of whether to make the inquiry should be based on factors such as his awareness that there are transactions or relationships which are unusual or complex between the component he is auditing and the component the principal auditor is auditing, or his knowledge that in the past matters relating to his audit have arisen that were known to the principal auditor but not to him.

**.07** If the other auditor believes inquiry is appropriate he may furnish the principal auditor with a draft of the financial statements expected to be issued and of his report solely for the purpose of aiding the principal auditor to respond to the inquiry. The inquiry would concern transactions, adjustments, or other matters that have come to the principal auditor's attention that he believes require adjustment to or disclosure in the financial statements of the component being audited by the other auditor. Also, the other auditor should inquire about any relevant limitation on the scope of the audit performed by the principal auditor.

[Issue Date: April, 1979.]

### **3. Form of Inquiries of the Principal Auditor Made by the Other Auditor**

**.08 Question**—In those circumstances when the other auditor believes an inquiry of the principal auditor is appropriate, what form should the inquiry take and when should it be made?

**.09 Interpretation**—The other auditor's inquiry ordinarily should be in writing. It should indicate whether the response should be in writing, and should specify the date as of which the principal auditor should respond. Ordinarily, that date should be near the anticipated date of the other auditor's report. An example of a written inquiry from the other auditor is as follows:

"We are auditing the financial statements of (name of client) as of (date) and for the (period of audit) for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles.

A draft of the financial statements referred to above and a draft of our report are enclosed solely to aid you in responding to this inquiry. Please provide us (in writing) (orally) with the following information in connection with your current examination of the consolidated financial statements of (name of parent company):

1. Transactions or other matters (including adjustments made during consolidation or contemplated at the date of your reply) that have come to your attention that you believe require adjustment to or disclosure in the financial statements of (name of client) being audited by us.

2. Any limitation on the scope of your audit that is related to the financial statements of (name of client) being audited by us, or that

limits your ability to provide us with the information requested in this inquiry.

Please make your response as of a date near (expected date of the other auditor's report)."

.10 The principal auditor's reply will often be made as of a date when his audit is still in progress; however, the other auditor should expect that ordinarily the response should satisfy his need for information. However, there may be instances when the principal auditor's response explains that it is limited because his audit has not progressed to a point that enables him to provide a response that satisfies the other auditor's need for information. If the principal auditor's response is limited in that manner, the other auditor should consider whether to apply acceptable alternative procedures, delay the issuance of his report until the principal auditor can respond, or qualify his report for a limitation on the scope of his audit.

[Issue Date: April, 1979]

#### **4. Form of Principal Auditor's Response to Inquiries from Other Auditors**

.11 *Question*—An independent auditor acting in the capacity of a principal auditor may receive an inquiry from another independent auditor performing the audit of the financial statements of a component concerning transactions, adjustments, or limitations on his audit.<sup>3</sup> What should be the form of the principal auditor's response?

.12 *Interpretation*—The principal auditor should respond promptly to the other auditor's inquiry, based on his audit, and if applicable, on his reading of the draft financial statements and report furnished by the other auditor. His response may be written or oral, as requested by the other auditor. However, the principal auditor's response ordinarily should be in writing if it contains information that may have a significant effect on the other auditor's audit.

.13 The principal auditor should identify the stage of completion of his audit as of the date of his reply. He should also indicate that no audit procedures were performed for the purpose of identifying matters that would not affect his audit and report, and therefore, not all the information requested would necessarily be revealed. If the principal auditor has been furnished with a draft of the financial statements being audited by the other auditor and a draft of his report, the principal auditor should state that he has read the draft only to aid him in making his reply.

.14 An example of a written response from the principal auditor is as follows:

"This letter is furnished to you in response to your request that we provide you with certain information in connection with your audit of the financial statements of (name of component), a (subsidiary, division, branch or investment) of Parent Company for the year ended (date).

We are in the process of performing an audit of the consolidated financial statements of Parent Company for the year ended (date) (but have not completed our work as of this date). The objective of our audit is to enable us to express an opinion on the consolidated financial statements of Parent Company and, accordingly, we have

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<sup>3</sup> See section 9543.04—.07, "Inquiries of the Principal Auditor by the Other Auditor," above.

performed no procedures directed toward identifying matters that would not affect our audit or our report. However, solely for the purpose of responding to your inquiry, we have read the draft of the financial statements of (name of component) as of (date) and for the (period of audit) and the draft of your report on them, included with your inquiry dated (date of inquiry).

Based solely on the work we have performed (to date) in connection with our audit of the consolidated financial statements, which would not necessarily reveal all or any of the matters covered in your inquiry, we advise you that:

1. No transactions or other matters (including adjustments made during consolidation or contemplated at this date) have come to our attention that we believe require adjustment to or disclosure in the financial statements of (name of component) being audited by you.

2. No limitation has been placed by Parent Company on the scope of our audit that, to our knowledge, is related to the financial statements (of name of component) being audited by you, that has limited our ability to provide you with the information requested in your inquiry.”

[Issue Date: April, 1979.]

## 5. Procedures of the Principal Auditor

**.15 Question**—What steps, if any, should the principal auditor take in responding to an inquiry such as that described in section 9543.11?

**.16 Interpretation**—The principal auditor’s response should ordinarily be made by the auditor with final responsibility for the engagement. He should take those steps that he considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor’s inquiry. For example, the auditor with final responsibility may inquire of principal assistants<sup>4</sup> responsible for various aspects of the engagement or he may direct assistants to bring to his attention any significant matters of which they become aware during the audit. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his audit or his report.

**.17** If between the date of his response and the completion of his audit, the principal auditor becomes aware of information that he would have included in his response to the other auditor’s inquiry had he been aware of it, the principal auditor should promptly communicate such information to the other auditor.<sup>5</sup>

[Issue Date: April, 1979.]

## 6. Application of Additional Procedures Concerning the Audit Performed by the Other Auditor

**.18 Question**—If a principal auditor decides not to make reference to the audit of another auditor, section 543 requires him to consider whether to apply

<sup>4</sup> See section 311, *Planning and Supervision*, for the definition of “assistants.”

<sup>5</sup> See section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report*, concerning procedures to be followed by the other auditor if he receives the information after the issuance of his report.

procedures to obtain information about the adequacy of the audit performed by the other auditor. In making a decision about (a) whether to apply one or more of the procedures listed in section 543.12 and (b), if applicable, the extent of those procedures, may the principal auditor consider his knowledge of the other auditor's compliance with quality control policies and procedures?

**.19 Interpretation**—Yes. The principal auditor's judgment about the extent of additional procedures, if any, to be applied in the circumstances may be affected by various factors including his knowledge of the other auditor's quality control policies and procedures that provide the other auditor with reasonable assurance of conformity with generally accepted auditing standards in his audit engagements.

**.20** Other factors that the principal auditor may wish to consider in making that decision include his previous experience with the other auditor, the materiality of the portion of the financial statements audited by the other auditor, the control exercised by the principal auditor over the conduct of the audit performed by the other auditor, and the results of the principal auditor's other procedures that may indicate whether additional evidential matter is necessary.

[Issue Date: December, 1981.]

## **7. Reporting on Financial Statements Presented on a Comprehensive Annual Financial Report of a Governmental Entity When One Fund Has Been Audited by Another Auditor**

**.21 Question**—The basic financial statements of a state or local governmental entity are the general purpose financial statements (GPFS), which present in columnar form the combined financial statements of each of the governmental entity's fund types and account groups. Governmental entities may choose to issue a comprehensive annual financial report (CAFR), which includes, in addition to the basic financial statements, combining financial statements and individual fund and account group financial statements.<sup>6</sup>

**.22** A governmental entity may engage an auditor to audit and report on the combining, individual fund, and account group financial statements (other than those of one individual fund), in addition to an opinion on the GPFS, when all these financial statements are presented together in a CAFR. That governmental entity may also engage another auditor to audit one fund's financial statements, which are included in the combining financial statements of one fund type. The auditor of the GPFS has concluded that he or she may serve as principal auditor of the GPFS. How should the principal auditor of the GPFS report on the financial statements included in the CAFR when the financial statements of one fund are audited by another auditor?

**.23 Answer**—It is not appropriate for the principal auditor of the GPFS to express an opinion on the financial statements of a fund audited by another auditor. Paragraph 18.31 of the AICPA audit and accounting guide *Audits of State and Local Governmental Units* states that "If the auditor is engaged to examine the combining and individual fund and account group financial statements in addition to a GPFS . . . the auditor's opinion addresses each presentation as a primary statement." Because the auditor's opinion separately addresses each fund's and each account group's financial position, the results of each fund's operations, and the changes in financial position of each proprietary fund and similar trust fund as presented in the combining,

<sup>6</sup> The relationships among the various financial statements included in a comprehensive annual financial report are illustrated in section 2200.601—.610 of the Governmental Accounting Standards Board's *Codification of Governmental Accounting and Financial Reporting Standards*.

individual fund, and account group financial statements, the auditor should make separate decisions about whether he or she may serve as principal auditor for each of these financial statements.

.24 The following is an example of a report that the principal auditor of the GPFS should issue when he or she is engaged to report on the general purpose, combining, individual fund, and account group financial statements (other than those of one individual fund), but has not audited the financial statements of one fund.

#### Independent auditor's report

We have audited the general purpose financial statements of the City of Example, Any State, and the combining, individual fund, and account group financial statements, other than the financial statements of the Parks Fund, of the City as of and for the year ended June 30, 19XX, as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the financial statements of the Parks Fund, which statements reflect total assets of \$\_\_\_\_\_ as of June 30, 19XX, and total revenues of \$\_\_\_\_\_ for the year then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion on the general purpose financial statements, insofar as it relates to the amounts included for the Parks Fund in the special revenue fund type is based solely on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general purpose financial statements referred to above present fairly, in all material respects, the financial position of the City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position<sup>7</sup> of its proprietary and similar trust fund types for the year then ended in conformity with generally accepted accounting principles. Also, in our opinion, the combining, individual fund, and account group financial statements of the City of Example, Any State, referred to above (other than the Parks Fund, whose financial statements were audited by other auditors whose report expressed an unqualified opinion) present fairly, in all material respects, the financial position of each of the individual funds and account groups at June 30, 19XX, and the results of operations of such funds and the changes in financial position of individual proprietary and similar trust funds for the year then ended, in conformity with generally accepted accounting principles.

[Issue Date: October, 1989.]

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[The next page is 861.]

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<sup>7</sup> The Governmental Accounting Standards Board plans to issue a final statement that will require proprietary funds and nonexpendable trust funds other than pension funds and public employee retirement systems to issue a statement of cash flows instead of a statement of changes in financial position. That statement is expected to be effective for fiscal periods beginning after December 15, 1989.

## AU Section 544

### ***Lack of Conformity With Generally Accepted Accounting Principles***

Sources: SAS No. 1, section 544; SAS No. 2; SAS No. 62.

See section 9544 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

[.01] [Superseded by Statement on Auditing Standards No. 2, effective December 31, 1974.]

#### **Regulated Companies**

.02 The basic postulates and broad principles of accounting comprehended in the term “generally accepted accounting principles” which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (Such companies include public utilities, common carriers, insurance companies, financial institutions, and the like.) Accordingly, the first reporting standard is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies; and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor’s report in the same manner followed for companies which are not regulated.<sup>1</sup> Ordinarily, this will require either a qualified or an adverse opinion on such statements. An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2. As amended by Statement on Auditing Standards No. 62, effective for reports issued on or after July 1, 1989.]

.03 It should be recognized, however, that appropriate differences exist with respect to the application of generally accepted accounting principles as between regulated and nonregulated businesses because of the effect in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses (FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulations* [AC section Re6]). Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues. It should also be recognized that accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses and

<sup>1</sup> When reporting on financial statements of a regulated company that are prepared in accordance with the requirements of financial reporting provisions of a government regulatory agency to whose jurisdiction the company is subject, the auditor may report on the financial statements as being prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (see section 623.02—.10, *Special Reports*). Reports of this nature, however, should be issued only if the financial statements are intended solely for filing with the regulatory agency or if additional distribution is recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation.



that the imposition of such accounting requirements does not necessarily mean that they conform with generally accepted accounting principles.

.04 When financial statements of a regulated company are prepared in accordance with a basis of accounting prescribed by its supervisory agency or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations other than filings with the company's regulatory agency. In those circumstances, except when such reporting is recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation, the auditor should use the standard form of report (see section 508.08, *Reports on Audited Financial Statements*), modified as appropriate (see section 508.49—.66) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting. [As amended by Statement on Auditing Standards No. 62, effective for reports issued on or after July 1, 1989.]

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[The next page is 911.]

## AU Section 550

### ***Other Information in Documents Containing Audited Financial Statements***

Source: SAS No. 8.

See section 9550 for interpretations of this section.

Issue date, unless otherwise indicated: December, 1975.

.01 An entity may publish various documents that contain information (hereinafter, "other information") in addition to audited financial statements and the independent auditor's report thereon. This section provides guidance for the auditor's consideration of other information included in such documents.

.02 This section is applicable only to other information contained in (a) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934 or (b) other documents to which the auditor, at the client's request, devotes attention.

.03 This section is not applicable when the financial statements and report appear in a registration statement filed under the Securities Act of 1933. The auditor's procedures with respect to 1933 Act filings are unaltered by this section (see sections 634<sup>†</sup> and 711<sup>††</sup>). Also, this section is not applicable to other information on which the auditor is engaged to express an opinion.<sup>1</sup> The guidance applicable to auditing and reporting on certain information other than financial statements intended to be presented in conformity with generally accepted accounting principles is unaltered by this section (see sections 551<sup>\*</sup> and 623<sup>\*\*</sup>).

.04 Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its

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<sup>†</sup> [Reference number 631, formerly 630, changed by the issuance of Statement on Auditing Standards No. 38 (superseded). Reference number 634, formerly 631, changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

<sup>††</sup> [Reference changed by issuance of Statement on Auditing Standards No. 37.] (See section 711.)

<sup>1</sup> Mere reading of other information is an inadequate basis for expressing an opinion on that information.

<sup>\*</sup> [Reference changed by issuance of Statement on Auditing Standards No. 29.] (See section 551.)

<sup>\*\*</sup> [Reference changed by issuance of Statement on Auditing Standards No. 62.] (See section 623.)

presentation, appearing in the financial statements.<sup>2</sup> If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, he should consider other actions such as revising his report to include an explanatory paragraph describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

.05 If, while reading the other information for the reasons set forth in paragraph .04, the auditor becomes aware of information that he believes is a material misstatement of fact that is not a material inconsistency as described in paragraph .04, he should discuss the matter with the client. In connection with this discussion, the auditor should consider that he may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the auditor concludes he has a valid basis for concern he should propose that the client consult with some other party whose advice might be useful to the client, such as the client's legal counsel.

.06 If, after discussing the matter as described in paragraph .05, the auditor concludes that a material misstatement of fact remains, the action he takes will depend on his judgment in the particular circumstances. He should consider steps such as notifying his client in writing of his views concerning the information and consulting his legal counsel as to further appropriate action in the circumstances.

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<sup>2</sup> In fulfilling his responsibility under this section, a principal auditor may also request the other auditor or auditors involved in the engagement to read the other information. If a predecessor auditor's report appears in a document to which this section applies, he should read the other information for the reasons described in this paragraph.

## AU Section 9550

### ***Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550***

The concepts of section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*, have a considerable effect on considerations auditors should make in evaluating management's reporting on the internal accounting control. The Auditing Standards Board is developing guidance to amend section 642, *Reporting on Internal Accounting Control*, that will, among other things, include a reconciliation of the concepts of section 9550 with those of section 319.

#### **1. Reports by Management on Internal Accounting Control**

**.01 Question**—Annual reports to shareholders may contain a report by management on its financial reporting responsibilities and related matters. A statement by management concerning the company's system of internal accounting control is a common subject in such reports.<sup>1</sup> What is the auditor's responsibility concerning such statement?

**.02 Interpretation**—Section 550, *Other Information in Documents Containing Audited Financial Statements*, makes clear that "the auditor has no obligation to corroborate other information contained in [such] a document." Under section 550, the auditor is required to read the report by management and consider whether it is materially inconsistent with information appearing in the financial statements and, as a result, he may become aware of a material misstatement of fact.<sup>2</sup>

**.03** The auditor would often be familiar with matters covered in a management statement on internal accounting control and may become aware of information that causes him to believe that management's statement concerning internal accounting control contains a material misstatement of fact as described in section 550. If the auditor becomes aware of information in the report by management that conflicts with his knowledge or understanding of such matters, he should discuss the conflict with the client. If, after discussions with the client, the auditor concludes that a material misstatement of fact exists (for example, if he has in fact communicated to management a weakness in internal accounting control he considers material and manage-

[The next page is 913-3.]

<sup>1</sup> For example, see *Conclusions and Recommendations of the Special Advisory Committee on Reports by Management* (AICPA) which states: "... the primary objective of the management report is to inform users of the various means, such as internal accounting control, by which management's responsibility for the financial statements is fulfilled." The Financial Executives Institute and the Securities and Exchange Commission also encourage the presentation of reports by management.

<sup>2</sup> Unless information on internal accounting control appears in the financial statements, which is not common, a management statement on internal accounting control could not be inconsistent with information appearing in financial statements.

ment states that he has not<sup>3</sup>), the auditor should consider steps such as notifying senior management and the board of directors or its audit committee in writing of his views concerning the information and consulting his legal counsel as to further appropriate action in the circumstances.

**.04** An auditor can reasonably expect that any uncorrected weaknesses in internal accounting control that he considered material and thus had communicated to management will have been considered by management in developing its statement on internal accounting control. The auditor should recognize, however, that management's consideration of a weakness that the auditor considers material may be only one of several factors in management's assessment of the company's system of internal accounting control. For example, management, after evaluating the costs of correction in relation to the expected benefits to be derived, may have concluded that corrective action for such a weakness is not practicable. The auditor would not be expected to independently test and form an opinion on management's conclusion in this highly subjective area. However, the auditor should consider the factors underlying management's assessment and if the auditor believes that management's statement on internal accounting control fails to disclose a fact needed to complete the statement in order for the statement made not to be a material misstatement, he should consider the steps described in the preceding paragraph.

**.05** The management report may refer to the independent auditor. However, the auditor should consider whether management's statement uses his name in such a way as to indicate or imply that his involvement is greater than is supported by the facts. For example, even though section 9325.01—.07 permits an auditor to report to management that he has not become aware of any material weaknesses during his examination, management should be discouraged from stating in a public report that the auditor has not identified any material weaknesses in internal accounting control in connection with his audit of the financial statements.<sup>4</sup> The foundation for such a statement in a public report could be misunderstood because it is not practicable for a report by management to adequately describe the varying extent of auditor's studies and evaluations of internal accounting control. Further, the fact that an audit has not disclosed any weaknesses the auditor considers material does not necessarily mean none exists since the auditor is not required under generally accepted auditing standards to evaluate each control or to identify every material weakness.

**.06** Reports by management may also discuss additional matters that management considers relevant to its operations, such as administrative controls. The auditor generally would have less familiarity with such matters

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<sup>3</sup> See the October 1978 auditing interpretation "Material Weaknesses in Accounting Control and the Foreign Corrupt Practices Act," (section 9317.03—.06) for guidance on what course of action should be followed by the auditor of a public entity when a material weakness in internal accounting control comes to his attention. In the context of an audit of financial statements, section 325.15 defines a material weakness as "a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions." [Footnote amended to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>4</sup> However, when the study and evaluation made as part of the audit is sufficient for expressing an opinion on the system, management may state that the auditor has not identified any material weaknesses. In these circumstances, to reduce the risk of misunderstanding, management should be encouraged to include in the document the auditor's report expressing an opinion on the system since it describes the objectives and limitations of internal accounting control and of accountants' evaluations of it or alternatively, the management report could include these descriptions.

than he has with matters of internal accounting control. Nevertheless, when an accountant believes there is a material misstatement of fact with respect to such information, he should discuss the matter with the client and consider whether any further action is needed in accordance with section 550.

[Issue Date: January, 1981.]

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## AU Section 551

### ***Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents***

(Supersedes section 610, "Long-Form Reports")<sup>1</sup>

Source: SAS No. 29; SAS No. 52.

Effective for auditors' reports dated on or after December 31, 1980, unless otherwise indicated.

.01 This section provides guidance on the form and content of reporting when an auditor submits to his client or to others a document that contains information in addition to the client's basic financial statements and the auditor's report thereon.

.02 The auditor's standard report covers the basic financial statements: balance sheet, statement of income, statement of retained earnings or changes in stockholders' equity, and statement of cash flows. The following presentations are considered part of the basic financial statements: descriptions of accounting policies, notes to financial statements, and schedules and explanatory material that are identified as being part of the basic financial statements. For purposes of this section, basic financial statements also include an individual basic financial statement, such as a balance sheet or statement of income and financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.

.03 The information covered by this section is presented outside the basic financial statements and is not considered necessary for presentation of financial position, results of operations, or cash flows in conformity with generally accepted accounting principles. Such information includes additional details or explanations of items in or related to the basic financial statements, consolidating information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity.

### **Reporting Responsibility**

.04 When an auditor submits a document containing audited financial statements to his client or to others, he has a responsibility to report on all the information included in the document. On the other hand, when the auditor's report is included in a client-prepared document<sup>2</sup> and the auditor is not engaged to report on information accompanying the basic financial statements, his responsibility with respect to such information is described in (a) section 550, *Other Information in Documents Containing Audited Financial*

<sup>1</sup> This section also supersedes the March 1979 auditing interpretation, "Reports on Consolidated Financial Statements That Include Supplementary Consolidating Information".

<sup>2</sup> Client-prepared documents include financial reports prepared by the client but merely reproduced by the auditor on the client's behalf.

*Statements*, and (b) other sections covering particular types of information or circumstances, such as section 558, *Required Supplementary Information*.

.05 An auditor's report on information accompanying the basic financial statements in an auditor-submitted document has the same objective as an auditor's report on the basic financial statements: to describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking. Although the auditor may participate in the preparation of the accompanying information as well as the basic financial statements, both the statements and the accompanying information are representations of management.

.06 The following guidelines apply to an auditor's report on information accompanying the basic financial statements in an auditor-submitted document:

- a. The report should state that the audit has been performed for the purpose of forming an opinion on the basic financial statements taken as a whole.
- b. The report should identify the accompanying information. (Identification may be by descriptive title or page number of the document.)
- c. The report should state that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements.<sup>3</sup>
- d. The report should include either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the audit of the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.
- e. The report on the accompanying information may be added to the auditor's report on the basic financial statements or may appear separately in the auditor-submitted document.

.07 The purpose of an audit of basic financial statements in accordance with generally accepted auditing standards is to form an opinion on those statements taken as a whole. Nevertheless, an audit of basic financial statements often encompasses information accompanying those statements in an auditor-submitted document. Also, although an auditor has no obligation to apply auditing procedures to information presented outside the basic financial statements, he may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements so that he may express an opinion on the accompanying information in the manner described in paragraph .06.

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<sup>3</sup> The auditor may refer to any regulatory agency requirements applicable to the information presented.



**.08** When reporting in this manner, the measurement of materiality is the same as that used in forming an opinion on the basic financial statements taken as a whole. Accordingly, the auditor need not apply procedures as extensive as would be necessary to express an opinion on the information taken by itself. Guidance applicable to the expression of an opinion on specified elements, accounts, or items of financial statements for the purpose of a separate presentation is provided in section 623.11—.18, *Special Reports*.

**.09** If the auditor concludes, on the basis of facts known to him, that any accompanying information is materially misstated in relation to the basic financial statements taken as a whole, he should discuss the matter with the client and propose appropriate revision of the accompanying information.<sup>4</sup> If the client will not agree to revision of the accompanying information, the auditor should either modify his report on the accompanying information and describe the misstatement or refuse to include the information in the document.

**.10** The auditor should consider the effect of any modifications in his standard report when reporting on accompanying information. When the auditor expresses a qualified opinion on the basic financial statements, he should make clear the effects upon any accompanying information as well (see paragraph .14). When the auditor expresses an adverse opinion, or disclaims an opinion, on the basic financial statements, he should not express the opinion described in paragraph .06 on any accompanying information.<sup>5</sup> An expression of such an opinion in these circumstances would be inappropriate because, like a piecemeal opinion, it may tend to overshadow or contradict the disclaimer of opinion or adverse opinion on the basic financial statements. (See section 508.73 and section 623.14.)

**.11** A client may request that nonaccounting information and certain accounting information not directly related to the basic financial statements be included in an auditor-submitted document. Ordinarily, such information would not have been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, the auditor would disclaim an opinion on it. In some circumstances, however, such information may have been obtained or derived from accounting records that have been tested by the auditor (for example, number of units produced related to royalties under a license agreement or number of employees related to a given payroll period). Accordingly, the auditor may be in a position to express an opinion on such information in the manner described in paragraph .06.

## Reporting Examples

**.12** An example of reporting on information accompanying the basic financial statements in an auditor-submitted document follows:

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements

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<sup>4</sup> See paragraph .10 for guidance when there is a modification of the auditor's standard report on the basic financial statements.

<sup>5</sup> The provisions of this paragraph do not change the guidance, concerning companies whose accounting practices are prescribed by governmental regulatory authorities or commissions, in the last sentence of section 544.02, "Regulated Companies," which reads: "An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles."

and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.<sup>6</sup>

.13 When the auditor disclaims an opinion on all or part of the accompanying information in a document that he submits to his client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances. Two examples follow.

#### *Disclaimer on All of the Information*

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify the accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

#### *Disclaimer on Part of the Information*

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX—YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

.14 An example follows of reporting on accompanying information to which a qualification in the auditor's report on the basic financial statements applies.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of investments (page 7), property (page 8), and other assets (page 9) as of December 31, 19XX, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such schedules has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, except for the effects on the schedule of investments of not accounting for the investments in certain companies by the equity method as explained in the second preceding paragraph [second paragraph of our report on page 1], such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

## **Supplementary Information Required by FASB or GASB Pronouncements**

.15 When supplementary information required by the FASB or GASB is presented outside the basic financial statements in an auditor-submitted document, the auditor should disclaim an opinion on the information unless he has been engaged to examine and express an opinion on it.<sup>7</sup> The following is an example of a disclaimer an auditor might use in these circumstances:

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<sup>6</sup> This form of reporting is not appropriate with respect to supplementary information required by the FASB (see paragraph .15).

<sup>7</sup> The guidance in subsection (b) of this paragraph applies to GASB required supplementary information, such as that required by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*. The auditor should refer to section 552, *Reporting on Condensed Financial Statements and Selected*

The [identify the supplementary information] on page XX is not a required part of the basic financial statements but is supplementary information required by the (Financial or Governmental) Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Also, the auditor's report should be expanded in accordance with section 558, *Required Supplementary Information*, paragraph .08, if (a) supplementary information that the FASB or GASB requires to be presented in the circumstances is omitted, (b) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from guidelines prescribed by the FASB or GASB, (c) the auditor is unable to complete the procedures prescribed by section 558, or (d) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. [As amended, April 1988, by Statement on Auditing Standards No. 58.]

## Consolidating Information

.16 Consolidated financial statements may include consolidating information or consolidating schedules presenting separate financial statements of one or more components of the consolidated group.<sup>8</sup> In some cases, the auditor is engaged to express an opinion on the financial statements of the components as well as on the consolidated financial statements. In other cases, the auditor is engaged to express an opinion only on the consolidated financial statements but consolidating information or schedules accompany the basic consolidated financial statements.

.17 When the auditor is engaged to express an opinion only on the consolidated financial statements and consolidating information is also included, the auditor should be satisfied that the consolidating information is suitably identified. For example, when the consolidated financial statements include columns of information about the components of the consolidated group, the balance sheets might be titled, "Consolidated Balance Sheet—December 31, 19X1, with Consolidated Information," and the columns including the consolidating information might be marked, "Consolidating Information." When the consolidating information is presented in separate schedules, the schedules presenting balance sheet information of the components might be titled, for example, "Consolidating Schedule, Balance Sheet Information, December 31, 19X1."

.18 When the consolidated financial statements include consolidating information that has not been separately audited, the auditor's report on the consolidating information might read

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly

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(Footnote Continued)

*Financial Data*, paragraphs .09—.10, for an example of a report on GASB required supplementary information.

<sup>8</sup> This section [paragraphs .16—.19] is also applicable to combined and combining financial statements.

stated in all material respects in relation to the consolidated financial statements taken as a whole.

.19 When the auditor is engaged to express an opinion on both the consolidated financial statements and the separate financial statements of the components presented in consolidating financial statements, the auditor's reporting responsibilities with respect to the separate financial statements are the same as his responsibilities with respect to the consolidated financial statements. In such cases, the consolidating financial statements and accompanying notes should include all the disclosures that would be necessary for presentation in conformity with generally accepted accounting principles of separate financial statements of each component.

### **Additional Commentary Concerning the Audit**

.20 The auditor may be requested to describe the procedures applied to specific items in the financial statements. Additional comments of this nature should not contradict or detract from the description of the scope of his audit in the standard report. Also, they should be set forth separately rather than interspersed with the information accompanying the basic financial statements to maintain a clear distinction between management's representations and the auditor's representations.

### **Co-existing Financial Statements**

.21 More than one type of document containing the audited financial statements may exist. For example, the auditor may submit to his client or others a document containing the basic financial statements, other information, and his report thereon, and the client may issue a separate document containing only the basic financial statements and the auditor's report. The basic financial statements should include all the information considered necessary for presentation in conformity with generally accepted accounting principles in all co-existing documents. The auditor should be satisfied that information accompanying the basic financial statements in an auditor-submitted document would not support a contention that the basic financial statements in the other document were not presented in conformity with generally accepted accounting principles because of inadequate disclosure of material information known to the auditor.

### **Effective Date**

.22 This section will be effective for auditors' reports dated on or after December 31, 1980.

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## AU Section 552

### ***Reporting on Condensed Financial Statements and Selected Financial Data***

Source: SAS No. 42; SAS No. 71.\*

Effective for reports issued or reissued on or after January 1, 1989, on condensed financial statements or selected financial data unless otherwise indicated.

.01 This section provides guidance on reporting in a client-prepared document on—

- a. Condensed financial statements (either for an annual or an interim period) that are derived from audited financial statements of a public entity<sup>1</sup> that is required to file, at least annually, complete audited financial statements with a regulatory agency.
- b. Selected financial data that are derived from audited financial statements of either a public or a nonpublic entity and that are presented in a document that includes audited financial statements (or, with respect to a public entity, that incorporates audited financial statements by reference to information filed with a regulatory agency).

Guidance on reporting on condensed financial statements or selected financial data that accompany audited financial statements in an auditor-submitted document is provided in section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

.02 In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in section 508, *Reports on Audited Financial Statements*, paragraphs .55 through .58, section 623, *Special Reports*, or other applicable Statements on Auditing Standards.<sup>2</sup>

### **Condensed Financial Statements**

.03 Condensed financial statements are presented in considerably less detail than complete financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. For this reason, they should be read in conjunction with the entity's most recent complete financial statements that include all the disclosures required by generally accepted accounting principles.

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\* Section amended to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

<sup>1</sup> *Public entity* is defined in section 504, *Association With Financial Statements*, footnote 2.

<sup>2</sup> An auditor who has audited and reported on complete financial statements of a nonpublic entity may subsequently be requested to compile financial statements for the same period that omit substantially all disclosures required by generally accepted accounting principles. Reporting on comparative financial statements in those circumstances is described in SSARS 2, paragraphs 29—30 [AR section 200.29—30].

.04 An auditor may be engaged to report on condensed financial statements that are derived from audited financial statements. Because condensed financial statements do not constitute a fair presentation of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles, an auditor should not report on condensed financial statements in the same manner as he reported on the complete financial statements from which they are derived. To do so might lead users to assume, erroneously, that the condensed financial statements include all the disclosures necessary for complete financial statements. For the same reason, it is desirable that the condensed financial statements be so marked.

.05 In the circumstances described in paragraph .01(a),<sup>3</sup> the auditor's report on condensed financial statements that are derived from financial statements that he has audited should indicate (a) that the auditor has audited and expressed an opinion on the complete financial statements, (b) the date of the auditor's report on the complete financial statements,<sup>4</sup> (c) the type of opinion expressed, and (d) whether, in the auditor's opinion, the information set forth in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.<sup>5</sup>

.06 The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(a) to report on condensed financial statements that are derived from financial statements that he has audited and on which he has issued a standard report:

Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the consolidated balance sheet of X Company and subsidiaries as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 19X1, we expressed an unqualified opinion on those consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

.07 A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have

<sup>3</sup> SEC regulations require certain registrants to include in filings, as a supplementary schedule to the consolidated financial statements, condensed financial information of the parent company. The auditor should report on such condensed financial information in the same manner as he reports on other supplementary schedules.

<sup>4</sup> Reference to the date of the original report removes any implication that records, transactions, or events after that date have been examined. The auditor does not have a responsibility to investigate or inquire further into events that may have occurred during the period between the date of the report on the complete financial statements and the date of the report on the condensed financial statements. (However, see section 711, *Filings Under Federal Securities Statutes*, regarding the auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933.)

<sup>5</sup> If the auditor's opinion on the complete financial statements was other than unqualified, the report should describe the nature of, and the reasons for, the qualification. The auditor should also consider the effect that any modification of the report on the complete financial statements might have on the report on the condensed financial statements or selected financial data. For example, if the auditor's report on the complete financial statements referred to another auditor or included an explanatory paragraph because of a material uncertainty, a going concern matter, or an inconsistency in the application of accounting principles, the report on the condensed financial statements should state that fact. However, no reference to the inconsistency is necessary if a change in accounting referred to in the auditor's report on the complete financial statements does not affect the comparability of the information being presented.

been derived from audited financial statements. Such a statement does not, in itself, require the auditor to report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency),<sup>6</sup> the auditor should request that the client either (a) not include the auditor's name in the document or (b), include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.<sup>7</sup>

.08 Condensed financial statements derived from audited financial statements of a public entity may be presented on a comparative basis with interim financial information as of a subsequent date that is accompanied by the auditor's review report. In that case, the auditor should report on the condensed financial statements of each period in a manner appropriate for the type of service provided for each period. The following is an example of a review report on a condensed balance sheet as of March 31, 19X1, and the related condensed statements of income and cash flows for the three-month periods ended March 31, 19X1 and 19X0, together with a report on a

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<sup>6</sup> If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency (at least annually), the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (See section 508, *Reports on Audited Financial Statements*, paragraphs .55 through .58.) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously audited and reported on the complete financial statements:

#### Independent Auditor's Report

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 19X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The condensed consolidated balance sheet as of December 31, 19X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by generally accepted accounting principles.

In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company and subsidiaries as of December 31, 19X0, or the results of its operations or its cash flows for the year then ended.

<sup>7</sup> In considering what other actions, if any, may be appropriate in these circumstances, the auditor may wish to consult his legal counsel.

condensed balance sheet derived from audited financial statements as of December 31, 19X0, included in Form 10-Q:<sup>8</sup>

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 19X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 19X1 and 19X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with generally accepted accounting principles.

We have previously audited, in accordance with generally accepted auditing standards, the consolidated balance sheet as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 19X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 19X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

[Paragraph amended to reflect the conforming changes necessary due to the issuance of SAS No. 71.]

## Selected Financial Data

.09 An auditor may be engaged to report on selected financial data that are included in a client-prepared document that contains audited financial statements (or, with respect to a public entity, that incorporates such statements by reference to information filed with a regulatory agency). Selected financial data are not a required part of the basic financial statements, and the entity's management is responsible for determining the specific selected

<sup>8</sup> Regulation S-X specifies that the following financial information should be provided in filings on Form 10-Q:

- a. An interim balance sheet as of the end of the most recent fiscal quarter and a balance sheet (which may be condensed to the same extent as the interim balance sheet) as of the end of the preceding fiscal year.
- b. Interim condensed statements of income for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year.
- c. Interim condensed cash flow statements for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter and for the corresponding period for the preceding fiscal year.

This financial information need not be audited, and, accordingly, there is no requirement for an auditor to report on condensed financial statements contained in Form 10-Q. If the auditor has made a review of interim financial information, however, he may agree to the reference to his name and the inclusion of his review report in a Form 10-Q. (See section 722, *Interim Financial Information*, paragraph .35.) [Reference changed by the issuance of Statement on Auditing Standards No. 71.]



financial data to be presented.<sup>9</sup> If the auditor is engaged to report on the selected financial data, his report should be limited to data that are derived from audited financial statements (which may include data that are calculated from amounts presented in the financial statements, such as working capital). If the selected financial data that management presents include both data derived from audited financial statements and other information (such as number of employees or square footage of facilities), the auditor's report should specifically identify the data on which he is reporting. The report should indicate (a) that the auditor has audited and expressed an opinion on the complete financial statements, (b) the type of opinion expressed,<sup>10</sup> and (c) whether, in the auditor's opinion, the information set forth in the selected financial data is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.<sup>11</sup> If the selected financial data for any of the years presented are derived from financial statements that were audited by another independent auditor, the report on the selected financial data should state that fact, and the auditor should not express an opinion on that data.

.10 The following is an example of an auditor's report that includes an additional paragraph because he is also engaged to report on selected financial data for a five-year period ended December 31, 19X5, in a client-prepared document that includes audited financial statements:

Independent Auditor's Report

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 19X5, in conformity with generally accepted accounting principles.

We have also previously audited, in accordance with generally accepted auditing standards, the consolidated balance sheets as of December 31, 19X3, 19X2, and 19X1, and the related statements of income, retained earnings, and cash flows for the years ended December 31, 19X2, and 19X1 (none of

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<sup>9</sup> Under regulations of the SEC, certain reports must include, for each of the last five fiscal years, selected financial data in accordance with regulation S-K, including net sales or operating revenues, income or loss from continuing operations, income or loss from continuing operations per common share, total assets, long-term obligations and redeemable preferred stock and cash dividends declared per common share. Registrants may include additional items that they believe may be useful. There is no SEC requirement for the auditor to report on selected financial data.

<sup>10</sup> See footnote 5.

<sup>11</sup> Nothing in this section is intended to preclude an auditor from expressing an opinion on one or more specified elements, accounts, or items of a financial statement, providing the provisions of section 623, *Special Reports*, are observed.

which are presented herein); and we expressed unqualified opinions on those consolidated financial statements.

In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 19X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

.11 In introductory material regarding the selected financial data included in a client-prepared document, an entity might name the independent auditor and state that the data are derived from financial statements that he audited. Such a statement does not, in itself, require the auditor to report on the selected financial data, provided that the selected financial data are presented in a document that contains audited financial statements (or, with respect to a public entity, that incorporates such statements by reference to information filed with a regulatory agency). If such a statement is made in a document that does not include (or incorporate by reference) audited financial statements, the auditor should request that neither his name nor reference to him be associated with the information, or he should disclaim an opinion on the selected financial data and request that the disclaimer be included in the document. If the client does not comply, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.<sup>12</sup>

.12 This section is effective for reports issued or reissued on or after January 1, 1989. Earlier application of the provision of this section is permissible.

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[The next page is 925.]

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<sup>12</sup> See footnote 7.

## AU Section 558

# ***Required Supplementary Information***

(Supersedes section 553)\*

**Source:** SAS No. 52.

**Issue date, unless otherwise indicated:** April, 1988.

.01 The Financial Accounting Standards Board (FASB) and Governmental Accounting Standards Board (GASB) develop standards for financial reporting, including standards for financial statements and for certain other information supplementary to financial statements.<sup>1</sup> This section provides the independent auditor with guidance on the nature of procedures to be applied to supplementary information required by the FASB or GASB, and describes the circumstances that would require the auditor to report such information.

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\* This section also withdraws the following Statements on Auditing Standards:

- Statement on Auditing Standards No. 28, *Supplementary Information on the Effects of Changing Prices* [Formerly section 554].
- Statement on Auditing Standards No. 40, *Supplementary Mineral Reserve Information* [Formerly section 556].
- Statement on Auditing Standards No. 45, *Supplementary Oil and Gas Reserve Information* [Formerly section 557].

SAS No. 45 was reissued as an auditing interpretation, see section 9558.01—.06.

<sup>1</sup> The FASB and GASB's roles in setting standards for financial reporting have been recognized by the AICPA Council. The FASB's authority to establish standards for disclosure of financial information outside of the basic financial statements is described in the following resolution:

That as of (September 19, 1987), the FASB, in respect of statements of financial accounting standards finally adopted by such board in accordance with its rules of procedure and the bylaws of the Financial Accounting Foundation, be, and hereby is, designated by this Council as the body to establish accounting principles pursuant to rule 203 and standards on disclosure of financial information for such entities outside financial statements in published financial reports containing financial statements under rule 202 of the *Rules of the Code of Professional Conduct* of the American Institute of Certified Public Accountants provided, however, any accounting research bulletins, or opinions of the accounting principles board issued or approved for exposure by the accounting principles board prior to April 1, 1973, and finally adopted by such board on or before June 30, 1973, shall constitute statements of accounting principles promulgated by a body designated by Council as contemplated in rule 203 of the *Rules of the Code of Professional Conduct* unless and until such time as they are expressly superseded by action of the FASB.

The GASB's authority to establish standards for financial reporting is described in the following resolution:

That as of (September 19, 1987), the GASB, with respect to statements of governmental accounting standards adopted and issued in July 1984 and subsequently in accordance with its rules of procedure and the bylaws of the FASB, be, and hereby is, designated by the Council of the American Institute of Certified Public Accountants as the body to establish financial accounting principles for state and local governmental entities pursuant to rule 203, and standards on disclosure of financial information for such entities outside financial statements in published financial reports containing financial statements under rule 202.

## Applicability

.02 This section is applicable in an audit in accordance with generally accepted auditing standards of financial statements included in a document that should contain supplementary information required by the FASB or GASB. However, this section is not applicable if the auditor has been engaged to audit such supplementary information.<sup>2</sup>

.03 Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph in his report on the audited financial statements a disclaimer on the information.<sup>3</sup> The following is an example of a disclaimer an auditor might use in these circumstances:

The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

When the auditor does not apply the procedures described in this section to a voluntary presentation of required supplementary information required for other entities, the provisions of section 550, apply.

## Involvement With Information Outside Financial Statements

.04 The objective of an audit of financial statements in accordance with generally accepted auditing standards is the expression of an opinion on such statements. The auditor has no responsibility to audit information outside the basic financial statements in accordance with generally accepted auditing standards. However, the auditor does have certain responsibilities with respect to information outside the financial statements. The nature of the auditor's responsibility varies with the nature of both the information and the document containing the financial statements.

.05 The auditor's responsibility for other information not required by the FASB or GASB but included in certain annual reports—which are client-prepared documents<sup>4</sup>—is specified in section 550. The auditor's responsibility for information outside the basic financial statements in documents that the auditor submits to the client or to others is specified in section 551. The auditor's responsibility for supplementary information required by the FASB or GASB (called *required supplementary information*) is discussed in the paragraphs that follow.

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<sup>2</sup> This section is not applicable to entities that voluntarily present supplementary information not required by the FASB or GASB. For example, entities that voluntarily present supplementary information on the effects of inflation and changes in specific prices, formerly required by FASB Statement No. 33, *Financial Reporting and Changing Prices*, are guided by section 550, *Other Information in Documents Containing Audited Financial Statements*.

<sup>3</sup> When supplementary information is presented in an auditor-submitted document outside the basic financial statements, the guidance in section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended by SAS No. 52, *Omnibus Statement on Auditing Standards—1987*, should be followed.

<sup>4</sup> Client-prepared documents include financial reports prepared by the client but merely reproduced by the auditor on the client's behalf.

## Involvement With Required Supplementary Information

.06 Required supplementary information differs from other types of information outside the basic financial statements because the FASB or GASB considers the information an essential part of the financial reporting of certain entities and because authoritative guidelines for the measurement and presentation of the information have been established. Accordingly, the auditor should apply certain limited procedures to required supplementary information and should report deficiencies in, or the omission of, such information.

### Procedures

.07 The auditor should consider whether supplementary information is required by the FASB or GASB in the circumstances. If supplementary information is required, the auditor ordinarily should apply the following procedures to the information.<sup>5</sup>

- a. Inquire of management about the methods of preparing the information, including (1) whether it is measured and presented within prescribed guidelines, (2) whether methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes, and (3) any significant assumptions or interpretations underlying the measurement or presentation.
- b. Compare the information for consistency with (1) management's responses to the foregoing inquiries, (2) audited financial statements,<sup>6</sup> and (3) other knowledge obtained during the examination of the financial statements.
- c. Consider whether representations on required supplementary information should be included in specific written representations obtained from management (section 333, *Client Representations*).
- d. Apply additional procedures, if any, that other statements, interpretations, guides, or statements of position prescribe for specific types of required supplementary information.
- e. Make additional inquiries if application of the foregoing procedures causes the auditor to believe that the information may not be measured or presented within applicable guidelines.

### Circumstances Requiring Reporting on Required Supplementary Information

.08 Since the supplementary information is not audited and is not a required part of the basic financial statements, the auditor need not add an explanatory paragraph to his report on the audited financial statements to refer to the supplementary information or to his limited procedures, except in

<sup>5</sup> These procedures are also appropriate when the auditor is involved with voluntary presentations of such information required for other entities (see paragraph .03).

<sup>6</sup> GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*, requires presentation of certain 10-year historical trend information relating to pension activities as supplementary information outside the basic financial statements. Such information is generally derived from financial statements. If such required supplementary information has been derived from audited financial statements and is presented outside the basic financial statements in an auditor-submitted document, the auditor may report on this information as indicated in section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*, paragraph .10.

any of the following circumstances: <sup>7</sup> (a) the supplementary information that the FASB or GASB requires to be presented in the circumstances is omitted; (b) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines; (c) the auditor is unable to complete the prescribed procedures; (d) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. Since the required supplementary information does not change the standards of financial accounting and reporting used for the preparation of the entity's basic financial statements, the circumstances described above do not affect the auditor's opinion on the fairness of presentation of such financial statements in conformity with generally accepted accounting principles. Furthermore, the auditor need not present the supplementary information if it is omitted by the entity. The following are examples of additional explanatory paragraphs an auditor might use in these circumstances.

#### **Omission of Required Supplementary Information**

The (Company or Governmental Unit) has not presented [*describe the supplementary information required by the FASB or GASB in the circumstances*] that the (Financial or Governmental) Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

#### **Material Departures From Guidelines**

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with guidelines established by the (Financial or Governmental) Accounting Standards Board because [*describe the material departure(s) from the FASB or GASB guidelines*].

#### **Prescribed Procedures Not Completed**

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

#### **Unresolved Doubts About Adherence to Guidelines**

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the (Financial or Governmental) Accounting Standards Board. [*The auditor should consider including in his report the reason(s) he was unable to resolve his substantial doubts.*]

Even though he is unable to complete the prescribed procedures, if, on the basis of facts known to him, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines,

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<sup>7</sup> When required supplementary information is presented outside the basic financial statements in an auditor-submitted document, the auditor should disclaim an opinion on the information unless he has been engaged to examine and express an opinion on it (see section 551.15).

he should suggest appropriate revision; failing that, he should describe the nature of any material departure(s) in his report.

**.09** If the entity includes with the supplementary information an indication that the auditor performed any procedures regarding the information without also indicating that the auditor does not express an opinion on the information presented, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the information.

**.10** Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB or GASB. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information.

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[The next page is 931.]

**AU Section 9558*****Required Supplementary Information:  
Auditing Interpretations of Section 558*****1. Supplementary Oil and Gas Reserve Information**

**.01 Question**—FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities* [AC section Oi5], which amended FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* [AC section Oi5], and FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies* [AC section Oi5], requires publicly traded entities that have significant oil and gas producing activities to include, with complete sets of annual financial statements, disclosures of proved oil and gas reserve quantities, changes in reserve quantities, a standardized measure of discounted future net cash flows relating to reserve quantities, and changes in the standardized measure. In documents filed with the Securities and Exchange Commission (SEC), Regulation S-K requires that the disclosures related to annual periods be presented for each annual period for which an income statement is required and the disclosures as of the end of an annual period be presented as of the date of each audited balance sheet required. These disclosures are considered to be supplementary information and may be presented outside the basic financial statements. In these circumstances, should the auditor consider the provisions of section 558, *Required Supplementary Information*?

**.02 Interpretation**—Yes. Also, in addition to the provisions of section 558, the auditor should also consider the provisions of this Interpretation.

**.03** Estimating oil and gas reserves is a complex process requiring the knowledge and experience of a reservoir engineer. In general, the quality of the estimate of proved reserves for an individual reservoir depends on the availability, completeness, and accuracy of data needed to develop the estimate and on the experience and judgment of the reservoir engineer. Estimates of proved reserves inevitably change over time as additional data become available and are taken into account. The magnitude of changes in these estimates is often substantial. Because oil and gas reserve estimates are more imprecise than most estimates that are made in preparing financial statements, entities are encouraged to explain the imprecise nature of such reserve estimates.

**.04** In applying the procedures specified in section 558, the auditor's inquiries should be directed to management's understanding of the specific requirements for disclosure of the supplementary oil and gas reserve information, including—

- a. The factors considered in determining the reserve quantity information to be reported, such as including in the information (1) quantities of all domestic and foreign proved oil and gas reserves owned by the entity net of interests of others, (2) reserves attributable to consolidated subsidiaries, (3) a proportionate share of reserves of investees that are proportionately consolidated, and (4) reserves relating to royalty interests owned.
- b. The separate disclosure of items such as (1) the entity's share of oil and gas produced from royalty interests for which reserve quantity



information is unavailable, (2) reserves subject to long-term agreements with governments or authorities in which the entity participates in the operation or otherwise serves as producer, (3) the entity's proportional interest in reserves of investees accounted for by the equity method, (4) subsequent events, important economic factors, or significant uncertainties affecting particular components of the reserve quantity information, (5) whether the entity's reserves are located entirely within its home country, and (6) whether certain named governments restrict the disclosure of reserves or require that the reserve estimates include reserves other than proved.

- c. The factors considered in determining the standardized measure of discounted future net cash flows to be reported.

.05 In addition, the auditor should also—

- a. Inquire about whether the person who estimated the entity's reserve quantity information has appropriate qualifications.<sup>1</sup>
- b. Compare the entity's recent production with its reserve estimates for properties that have significant production or significant reserve quantities and inquire about disproportionate ratios.
- c. Compare the entity's reserve quantity information with the corresponding information used for depletion and amortization, and make inquiries when differences exist.
- d. Inquire about the calculation of the standardized measure of discounted future net cash flows. These inquiries might include matters such as whether—
  - i. The prices used to develop future cash inflows from estimated production of the proved reserves are based on prices received at the end of the entity's fiscal year, and whether the calculation of future cash inflows appropriately reflects the terms of sales contracts and applicable governmental laws and regulations.
  - ii. The entity's estimate of the nature and timing of future development of the proved reserves and the future rates of production are consistent with available development plans.
  - iii. The entity's estimates of future development and production costs are based on year-end costs and assumed continuation of existing economic conditions.
  - iv. Future income tax expenses have been computed using the appropriate year-end statutory tax rates, with consideration of future tax rates already legislated, after giving effect to the tax

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<sup>1</sup> For example, the Society of Petroleum Engineers has prepared "Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserve Information," which indicate that a reserve estimator would normally be considered to be qualified if he or she (1) has a minimum of three years' practical experience in petroleum engineering or petroleum production geology, with at least one year of such experience being in the estimation and evaluation of reserve information; and (2) either (a) has obtained, from a college or university of recognized stature, a bachelor's or advanced degree in petroleum engineering, geology, or other discipline of engineering or physical science or (b) has received, and is maintaining in good standing, a registered or certified professional engineer's license or a registered or certified professional geologist's license, or the equivalent thereof, from an appropriate governmental authority or professional organization.

basis of the properties involved, permanent differences, and tax credits and allowances.

- v. The future net cash flows have been appropriately discounted.
  - vi. With respect to full cost companies, the estimated future development costs are consistent with the corresponding amounts used for depletion and amortization purposes.
  - vii. With respect to the disclosure of changes in the standardized measure of discounted future net cash flows, the entity has computed and presented the sources of the changes in conformity with the requirements of FASB Statement No. 69 [AC section 0i5].
- e. Inquire about whether the methods and bases for estimating the entity's reserve information are documented and whether the information is current.

.06 If the auditor believes that the information may not be presented within the applicable guidelines, section 558 indicates that he ordinarily should make additional inquiries. However, because of the nature of estimates of oil and gas reserve information, the auditor may not be in a position to evaluate the responses to such additional inquiries and, thus, will need to report this limitation on the procedures prescribed by professional standards. The following is an example that illustrates reporting on oil and gas reserve information in that event.

The oil and gas reserve information is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the Financial Accounting Standards Board. [The auditor should consider including in his report the reason(s) why he was unable to resolve his doubts. For example, the auditor may wish to state that the information was estimated by a person lacking appropriate qualifications.]

[Issue Date: February, 1989.]

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[The next page is 941.]

## AU Section 560

### ***Subsequent Events***

Sources: SAS No. 1, section 560; SAS No. 12.

Issue date, unless otherwise indicated: November, 1972.

.01 An independent auditor's report ordinarily is issued in connection with historical financial statements that purport to present financial position at a stated date and results of operations and cash flows for a period ended on that date. However, events or transactions sometimes occur subsequent to the balance-sheet date, but prior to the issuance of the financial statements and auditor's report, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements. These occurrences hereinafter are referred to as "subsequent events."

.02 Two types of subsequent events require consideration by management and evaluation by the independent auditor.

.03 The first type consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

.04 Identifying events that require adjustment of the financial statements under the criteria stated above calls for the exercise of judgment and knowledge of the facts and circumstances. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance-sheet date would be indicative of conditions existing at the balance-sheet date, thereby calling for adjustment of the financial statements before their issuance. On the other hand, a similar loss resulting from a customer's major casualty such as a fire or flood subsequent to the balance-sheet date would not be indicative of conditions existing at the balance-sheet date and adjustment of the financial statements would not be appropriate. The settlement of litigation for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the events, such as personal injury or patent infringement, that gave rise to the litigation had taken place prior to the balance-sheet date.

.05 The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements.<sup>1</sup> Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the

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<sup>1</sup> This paragraph is not intended to preclude giving effect in the balance sheet, with appropriate disclosure, to stock dividends or stock splits or reverse splits consummated after the balance-sheet date but before issuance of the financial statements.

historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements. (See AT section 300, *Reporting on Pro Forma Financial Information*.)

**.06** Examples of events of the second type that require disclosure to the financial statements (but should not result in adjustment) are:

- a. Sale of a bond or capital stock issue.
- b. Purchase of a business.
- c. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance-sheet date.
- d. Loss of plant or inventories as a result of fire or flood.
- e. Losses on receivables resulting from conditions (such as a customer's major casualty) arising subsequent to the balance-sheet date.

**.07** Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements (see paragraph .03) because such events typically represent the culmination of conditions that existed over a relatively long period of time. Subsequent events such as changes in the quoted market prices of securities ordinarily should not result in adjustment of the financial statements (see paragraph .05) because such changes typically reflect a concurrent evaluation of new conditions.

**.08** When financial statements are reissued, for example, in reports filed with the Securities and Exchange Commission or other regulatory agencies, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of financial statements should not result in adjustment of the financial statements<sup>2</sup> unless the adjustment meets the criteria for the correction of an error or the criteria for prior period adjustments set forth in Opinions of the Accounting Principles Board.\* Similarly, financial statements reissued in comparative form with financial statements of subsequent periods should not be adjusted for events occurring subsequent to the original issuance unless the adjustment meets the criteria stated above.

**.09** Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an explanatory paragraph directing the reader's attention to the event and its effects. (See section 508.37.)

## **Auditing Procedures in the Subsequent Period**

**.10** There is a period after the balance-sheet date with which the auditor must be concerned in completing various phases of his audit. This period is known as the "subsequent period" and is considered to extend to the date of the auditor's report. Its duration will depend upon the practical requirements of each audit and may vary from a relatively short period to one of several months. Also, all auditing procedures are not carried out at the same time and some phases of an audit will be performed during the subsequent period, whereas other phases will be substantially completed on or before the balance-

<sup>2</sup> However, see paragraph .05 as to the desirability of presenting pro forma financial statements to supplement the historical financial statements in certain circumstances.

\* See also Statement of Financial Accounting Standards No. 16, *Prior Period Adjustments* (AC section A35).

sheet date. As an audit approaches completion, the auditor will be concentrating on the unresolved auditing and reporting matters and he is not expected to be conducting a continuing review of those matters to which he has previously applied auditing procedures and reached satisfaction.

.11 Certain specific procedures are applied to transactions occurring after the balance-sheet date such as (a) the examination of data to assure that proper cutoffs have been made and (b) the examination of data which provide information to aid the auditor in his evaluation of the assets and liabilities as of the balance-sheet date.

.12 In addition, the independent auditor should perform other auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles. These procedures should be performed at or near the completion of the field work. The auditor generally should:

- a. Read the latest available interim financial statements; compare them with the financial statements being reported upon; and make any other comparisons considered appropriate in the circumstances. In order to make these procedures as meaningful as possible for the purpose expressed above, the auditor should inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under audit.
- b. Inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:
  - (i) Whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of inquiry.
  - (ii) Whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.
  - (iii) The current status of items, in the financial statements being reported on, that were accounted for on the basis of tentative, preliminary, or inconclusive data.
  - (iv) Whether any unusual adjustments had been made during the period from the balance-sheet date to the date of inquiry.
- c. Read the available minutes of meetings of stockholders, directors, and appropriate committees; as to meetings for which minutes are not available, inquire about matters dealt with at such meetings.
- d. Inquire of client's legal counsel concerning litigation, claims, and assessments. [As amended, January 1976, by Statement on Auditing Standards No. 12.] (See section 337.)
- e. Obtain a letter of representations, dated as of the date of the auditor's report, from appropriate officials, generally the chief executive officer and chief financial officer, as to whether any events occurred subsequent to the date of the financial statements being reported on by the independent auditor that in the officer's opinion

would require adjustment or disclosure in these statements. The auditor may elect to have the client include representations as to significant matters disclosed to the auditor in his performance of the procedures in subparagraphs (a) to (d) above and (f) below. (See section 333, *Client Representation*)

- f. Make such additional inquiries or perform such procedures as he considers necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries, and discussions.
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[The next page is 951.]

**AU Section 561*****Subsequent Discovery of  
Facts Existing at the Date  
of the Auditor's Report***

Source: SAS No. 1, section 561.

Issue date, unless otherwise indicated: November, 1972.

.01 The procedures described in this section should be followed by the auditor who, subsequent to the date of his report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts.

.02 Because of the variety of conditions which might be encountered, some of these procedures are necessarily set out only in general terms; the specific actions to be taken in a particular case may vary somewhat in the light of the circumstances. The auditor would be well advised to consult with his attorney when he encounters the circumstances to which this section may apply because of legal implications that may be involved in actions contemplated herein, including, for example, the possible effect of state statutes regarding confidentiality of auditor-client communications.

.03 After he has issued his report, the auditor has no obligation<sup>1</sup> to make any further or continuing inquiry or perform any other auditing procedures with respect to the audited financial statements covered by that report, unless new information which may affect his report comes to his attention. In addition, this section does not apply to situations arising from developments or events occurring after the date of the auditor's report; neither does it apply to situations where, after issuance of the auditor's report, final determinations or resolutions are made of contingencies or other matters which had been disclosed in the financial statements or which had resulted in a departure from the auditor's standard report.

.04 When the auditor becomes aware of information which relates to financial statements previously reported on by him, but which was not known to him at the date of his report, and which is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his audit, he should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of his report. In this connection, the auditor should discuss the matter with his client at whatever management levels he deems appropriate, including the board of directors, and request cooperation in whatever investigation may be necessary.

.05 When the subsequently discovered information is found both to be reliable and to have existed at the date of the auditor's report, the auditor

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<sup>1</sup> However, see section 711.10—13 as to an auditor's obligation with respect to audited financial statements included in registration statements filed under the Securities Act of 1933 between the date of the auditor's report and the effective date of the registration statement. [Reference changed by issuance of Statement on Auditing Standards No. 37.]

should take action in accordance with the procedures set out in subsequent paragraphs if the nature and effect of the matter are such that (a) his report would have been affected if the information had been known to him at the date of his report and had not been reflected in the financial statements and (b) he believes there are persons currently relying or likely to rely on the financial statements who would attach importance to the information. With respect to (b), consideration should be given, among other things, to the time elapsed since the financial statements were issued.

**.06** When the auditor has concluded, after considering (a) and (b) in paragraph .05, that action should be taken to prevent future reliance on his report, he should advise his client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report. When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances.

- a. If the effect on the financial statements or auditor's report of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report. Generally, only the most recently issued audited financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.<sup>2</sup>
- b. When issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements pursuant to subparagraph (a).<sup>3</sup>
- c. When the effect on the financial statements of the subsequently discovered information cannot be determined without a prolonged investigation, the issuance of revised financial statements and auditor's report would necessarily be delayed. In this circumstance, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of notification by the client to persons who are known to be relying or who are likely to rely on the financial statements and the related report that they should not be relied upon, and that revised financial statements and auditor's report will be issued upon completion of an investigation. If applicable, the client should be advised to discuss with the Securities and Exchange Commission, stock exchanges, and appropriate regulatory agencies the disclosure to be made or other measures to be taken in the circumstances.

**.07** The auditor should take whatever steps he deems necessary to satisfy himself that the client has made the disclosures specified in paragraph .06.

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<sup>2</sup> See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 [AC section A35.107—.108] and paragraphs 36 and 37 of Opinion No. 20 [AC section A35.105] regarding disclosure of adjustments applicable to prior periods.

<sup>3</sup> Ibid.



**.08** If the client refuses to make the disclosures specified in paragraph .06, the auditor should notify each member of the board of directors of such refusal and of the fact that, in the absence of disclosure by the client, the auditor will take steps as outlined below to prevent future reliance upon his report. The steps that can appropriately be taken will depend upon the degree of certainty of the auditor's knowledge that there are persons who are currently relying or who will rely on the financial statements and the auditor's report, and who would attach importance to the information, and the auditor's ability as a practical matter to communicate with them. Unless the auditor's attorney recommends a different course of action, the auditor should take the following steps to the extent applicable:

- a. Notification to the client that the auditor's report must no longer be associated with the financial statements.
- b. Notification to regulatory agencies having jurisdiction over the client that the auditor's report should no longer be relied upon.
- c. Notification to each person known to the auditor to be relying on the financial statements that his report should no longer be relied upon. In many instances, it will not be practicable for the auditor to give appropriate individual notification to stockholders or investors at large, whose identities ordinarily are unknown to him; notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the auditor to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure. The Securities and Exchange Commission and the stock exchanges are appropriate agencies for this purpose as to corporations within their jurisdictions.

**.09** The following guidelines should govern the content of any disclosure made by the auditor in accordance with paragraph .08 to persons other than his client:

- a. If the auditor has been able to make a satisfactory investigation of the information and has determined that the information is reliable:
  - (i) The disclosure should describe the effect the subsequently acquired information would have had on the auditor's report if it had been known to him at the date of his report and had not been reflected in the financial statements. The disclosure should include a description of the nature of the subsequently acquired information and of its effect on the financial statements.
  - (ii) The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose mentioned in the preceding subparagraph (i). Comments concerning the conduct or motives of any person should be avoided.
- b. If the client has not cooperated and as a result the auditor is unable to conduct a satisfactory investigation of the information, his disclosure need not detail the specific information but can merely indicate that information has come to his attention which his client has not cooperated in attempting to substantiate and that, if the information is true, the auditor believes that his report must no longer be

relied upon or be associated with the financial statements. No such disclosure should be made unless the auditor believes that the financial statements are likely to be misleading and that his report should not be relied on.

.10 The concepts embodied in this section are not limited solely to corporations but apply in all cases where financial statements have been audited and reported on by independent auditors.

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[The next page is 961.]

**AU Section 9561*****Subsequent Discovery of Facts Existing at the Date of the Auditor's Report: Auditing Interpretations of Section 561*****1. Auditor Association With Subsequently Discovered Information When the Auditor Has Resigned or Been Discharged**

.01 *Question*—New information may come to an auditor's attention subsequent to the date of his report on audited financial statements that might affect the previously issued audit report. Is the auditor's responsibility with respect to that information different if the auditor has resigned or been discharged prior to undertaking or completing his investigation than if he were the continuing auditor?

.02 *Interpretation*—No. Section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, requires the auditor to undertake to determine whether the information is reliable and whether the facts existed at the date of his report. This undertaking must be performed even when the auditor has resigned or been discharged.

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AU Section 600

OTHER TYPES OF  
REPORTS

... special reports ... reports on the application of  
accounting principles ... letters for underwriters  
... reporting on internal accounting control ...

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## Paragraph

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**AU Section 622*****Special Reports—Applying  
Agreed-Upon Procedures to  
Specified Elements, Accounts, or  
Items of a Financial Statement***

(Supersedes Statement on Auditing Standards No. 14, paragraphs 15—17)<sup>1</sup>

**Source:** SAS No. 35.

**Issue date, unless otherwise indicated:** April, 1981.

.01 An accountant may accept an engagement in which the scope is limited to applying to one or more specified elements, accounts, or items of a financial statement agreed-upon procedures<sup>2</sup> that are not sufficient to enable him to express an opinion on the specified elements, accounts, or items, provided (a) the parties involved have a clear understanding of the procedures to be performed and (b) distribution of the report is to be restricted to named parties involved.<sup>3</sup>

.02 To satisfy the requirement that the parties involved have a clear understanding of the procedures to be performed, ordinarily the accountant should meet with the named parties involved to discuss the procedures to be followed. This discussion may include describing to the named parties procedures frequently followed in similar types of engagements. Sometimes the accountant may not be able to discuss the procedures directly with all the parties who will receive the report. In such circumstances, the accountant may satisfy the requirement that the parties involved have a clear understanding by applying any one of the following or similar procedures:

- a. Discussing the procedures to be applied with legal counsel or other appropriate representatives of the parties involved, such as a trustee, a receiver, or a creditors' committee.
- b. Reviewing relevant correspondence from the parties.
- c. Comparing the procedures to be applied to written requirements of a supervisory agency, such as a bank regulatory agency that receives a report in connection with a bank directors' examination.

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<sup>1</sup> For guidance when reporting on a review of one or more specified elements, accounts or items of a financial statement, the accountant should refer to AT Section 100, *Attestation Standards*.

<sup>2</sup> Mere reading of a specific element, account, or item does not constitute a procedure sufficient to permit an accountant to report on the results of applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement.

<sup>3</sup> The form of reporting described in paragraph .04 is appropriate, even though by law or regulation the accountant's report may be made a matter of public record.

- d. Distributing a draft of the report or a copy of the client's engagement letter to the parties involved with a request for their comments before the report is issued.

.03 The second and third standards of field work and the standards of reporting do not apply to an engagement that is limited to applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement; however, the general standards and the first standard of field work are applicable.

.04 The accountant's report on the results of applying agreed-upon procedures should (a) indicate the specified elements, accounts, or items to which the agreed-upon procedures were applied, (b) indicate the intended distribution of the report, (c) enumerate the procedures performed, (d) state the accountant's findings, (e) disclaim an opinion with respect to the specified elements, accounts, or items, and (f) state that the report relates only to the elements, accounts, or items specified, and does not extend to the entity's financial statements taken as a whole.<sup>4</sup>

.05 If the accountant has no adjustments to propose to the specified elements, accounts, or items, he may include a comment to that effect in his report. For example, the following language might be included: "In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the (specified elements, accounts, or items) should be adjusted." Also, the accountant may wish to indicate that had he performed additional procedures with respect to the specified elements, accounts, or items or had he performed an audit of the financial statements in accordance with generally accepted auditing standards, (other) matters might have come to his attention that would have been reported.

.06 The following are illustrations of the types of reports that might be issued when an engagement is limited to applying to one or more specified elements, accounts, or items of a financial statement agreed-upon procedures that are not sufficient to enable the accountant to express an opinion on the elements, accounts, or items.

#### *Report in Connection With a Proposed Acquisition*

Board of Directors

X Company

We have applied certain agreed-upon procedures, as discussed below, to accounting records of Y Company, Inc., as of December 31, 19XX, solely to assist you in connection with the proposed acquisition of Y Company, Inc. It is understood that this report is solely for your information and is not to be referred to or distributed for any purpose to anyone who is not a member of management of X Company. Our procedures and findings are as follows:

- a. We reconciled cash on deposit with the following banks to the balances in the respective general ledger accounts and obtained confirmation of the related balances from the banks.

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<sup>4</sup> When the accountant consents to the inclusion of his report on the results of applying agreed-upon procedures in a document or written communication containing the entity's financial statements, he should look to section 504, *Association With Financial Statements*, or to Statement on Standards for Accounting and Review Services No. 1 [AR section 100], *Compilation and Review of Financial Statements*, as appropriate, for guidance on his responsibility pertaining to the financial statements.

<i>Bank</i>	<i>Balance Per General Ledger</i>
ABC National Bank	\$ 5,000
DEF State Bank	13,776
XYZ Trust Company—regular account	86,912
XYZ Trust Company—payroll account	5,000

b. We obtained an aged trial balance of the accounts receivable subsidiary records, traced the age and amounts of approximately 10 percent of the accounts to the accounts receivable ledger, and added the trial balance and compared the total with the balance in the general ledger control account. We mailed requests for positive confirmation of balances to 150 customers. The differences disclosed in confirmation replies were minor in amount and nature, and we reconciled them to our satisfaction. The results are summarized as follows:

	<i>Accounts Receivable Aging and Confirmation</i>		
	<i>Account Balance</i>	<i>Confirmation Results Requested</i>	<i>Received</i>
Current .....	\$156,000	\$ 76,000	\$ 65,000
Past due:			
Less than one month .....	60,000	30,000	19,000
One to three months .....	36,000	18,000	10,000
Over three months .....	48,000	48,000	8,000
	<u>\$300,000</u>	<u>\$172,000</u>	<u>\$102,000</u>

Because the above procedures do not constitute an audit conducted in accordance with generally accepted auditing standards, we do not express an opinion on any of the accounts or items referred to above. In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the specified accounts or items should be adjusted. Had we performed additional procedures or had we conducted an audit of the financial statements in accordance with generally accepted auditing standards, matters might have come to our attention that would have been reported to you. This report relates only to the accounts and items specified above and does not extend to any financial statements of Y Company, Inc., taken as a whole.

### *Report in Connection With Claims of Creditors*

Trustee  
XYZ Company

At your request, we have performed the procedures enumerated below with respect to the claims of creditors of XYZ Company as of May 31, 19XX, set forth in the accompanying schedules. Our review was made solely to assist you in evaluating the reasonableness of those claims, and our report is not to be used for any other purpose. The procedures we performed are summarized as follows:

a. We compared the total of the trial balance of accounts payable at May 31, 19XX, prepared by the company, to the balance in the company's related general ledger account.

b. We compared the claims received from creditors to the trial balance of accounts payable.

c. We examined documentation submitted by the creditors in support of their claims and compared it to documentation in the company's files, including invoices, receiving records, and other evidence of receipt of goods or services.

Our findings are presented in the accompanying schedules. Schedule A lists claims that are in agreement with the company's records. Schedule B

lists claims that are not in agreement with the company's records and sets forth the differences in amounts.

Because the above procedures do not constitute an audit conducted in accordance with generally accepted auditing standards, we do not express an opinion on the accounts payable balance as of May 31, 19XX. In connection with the procedures referred to above, except as set forth in Schedule B, no matters came to our attention that caused us to believe that the accounts payable balance might require adjustment. Had we performed additional procedures or had we conducted an audit of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you. This report relates only to the accounts and items specified above and does not extend to any financial statements of XYZ Company, taken as a whole.

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[The next page is 1077.]

## AU Section 623

### ***Special Reports***

(Supersedes section 621)

Source: SAS No. 62.

See section 9623 for interpretations of this section.

Effective for reports issued on or after July 1, 1989, unless otherwise indicated.

### **Introduction**

.01 This section applies to auditors' reports issued in connection with the following:

- a. Financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles (paragraphs .02 through .10)
- b. Specified elements, accounts, or items of a financial statement (paragraphs .11 through .18)
- c. Compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements (paragraphs .19 through .21)
- d. Financial presentations to comply with contractual agreements or regulatory provisions (paragraphs .22 through .30)
- e. Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's reports (paragraphs .32 and .33)

### **Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles**

.02 Generally accepted auditing standards are applicable when an auditor conducts an audit of and reports on any financial statement. A financial statement may be, for example, that of a corporation, a consolidated group of corporations, a combined group of affiliated entities, a not-for-profit organization, a governmental unit, an estate or trust, a partnership, a proprietorship, a segment of any of these, or an individual. The term *financial statement* refers to a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in conformity with a comprehensive basis of accounting. For reporting purposes, the independent auditor should consider each of the following types of financial presentations to be a financial statement:

- a. Balance sheet
- b. Statement of income or statement of operations
- c. Statement of retained earnings

- d. Statement of cash flows
- e. Statement of changes in owners' equity
- f. Statement of assets and liabilities that does not include owners' equity accounts
- g. Statement of revenue and expenses
- h. Summary of operations
- i. Statement of operations by product lines
- j. Statement of cash receipts and disbursements

.03 An independent auditor's judgment concerning the overall presentation of financial statements should be applied within an identifiable framework (see section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*). Normally, the framework is provided by generally accepted accounting principles, and the auditor's judgment in forming an opinion is applied accordingly (see section 411.05). In some circumstances, however, a comprehensive basis of accounting other than generally accepted accounting principles may be used. [Reference deleted by the issuance of Statement on Auditing Standards No. 69, January 1992.]

.04 For purposes of this section, a comprehensive basis of accounting other than generally accepted accounting principles is one of the following—

- a. A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.
- b. A basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.
- c. The cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes.
- d. A definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

Unless one of the foregoing descriptions applies, reporting under the provisions of paragraph .05 is not permitted.

### **Reporting on Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)**

.05 When reporting on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles, as defined in paragraph .04, an independent auditor should include in the report—

- a. A title that includes the word *independent*.<sup>1</sup>
- b. A paragraph that—

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<sup>1</sup> This section does not require a title for an auditor's report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent.

- (1) States that the financial statements identified in the report were audited.
  - (2) States that the financial statements are the responsibility of the Company's management <sup>2</sup> and that the auditor is responsible for expressing an opinion on the financial statements based on the audit.
- c. A paragraph that—
- (1) States that the audit was conducted in accordance with generally accepted auditing standards.
  - (2) States that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
  - (3) States that an audit includes—
    - (a) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,
    - (b) Assessing the accounting principles used and significant estimates made by management, and
    - (c) Evaluating the overall financial statement presentation (see paragraph .09).
  - (4) States that the auditor believes that his or her audit provides a reasonable basis for the opinion.
- d. A paragraph that—
- (1) States the basis of presentation and refers to the note to the financial statements that describes the basis (see paragraphs .09 and .10).
  - (2) States that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.
- e. A paragraph that expresses the auditor's opinion (or disclaims an opinion) on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described. If the auditor concludes that the financial statements are not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, he or she should disclose all the substantive reasons for the conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph the appropriate modifying language and a reference to such explanatory paragraph(s).<sup>3</sup>
- f. If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency (see paragraph .04a), a paragraph that restricts the distribution of the report solely to those within the entity and

<sup>2</sup> In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's standard report or referenced to management's report.

<sup>3</sup> Paragraph .31 discusses other circumstances that may require that the auditor add additional explanatory language to the special report.

for filing with the regulatory agency. Such a restrictive paragraph is appropriate, even though by law or regulation the auditor's report may be made a matter of public record. However, the auditor may use this form of report only if the financial statements and report are intended solely for filing with the regulatory agency to whose jurisdiction the entity is subject or if additional distribution is recognized as appropriate by an AICPA audit or accounting guide or auditing interpretation.<sup>4</sup>

- g. The manual or printed signature of the auditor's firm.
- h. The date.<sup>5</sup>

.06 Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph .04, the auditor should use the standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph .08) modified as appropriate because of the departures from generally accepted accounting principles.

.07 Terms such as *balance sheet*, *statement of financial position*, *statement of income*, *statement of operations*, and *statement of cash flows*, or similar unmodified titles are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in conformity with generally accepted accounting principles. Consequently, the auditor should consider whether the financial statements that he or she is reporting on are suitably titled. For example, cash basis financial statements might be titled *statement of assets and liabilities arising from cash transactions*, or *statement of revenue collected and expenses paid*, and a financial statement prepared on a statutory or regulatory basis might be titled *statement of income—statutory basis*. If the auditor believes that the financial statements are not suitably titled, the auditor should disclose his or her reservations in an explanatory paragraph of the report and qualify the opinion.

.08 Following are illustrations of reports on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.

### Financial Statements Prepared on a Basis Prescribed by a Regulatory Agency Solely for Filing With That Agency

#### Independent Auditor's Report

We have audited the accompanying statements of admitted assets, liabilities, and surplus—statutory basis of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the related statements of income and cash flows—statutory basis and changes in surplus—statutory basis for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to

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<sup>4</sup> If the financial statements and report are intended for distribution other than for filing with the regulatory agency to whose jurisdiction the entity is subject or if such additional distribution is not recognized as appropriate by an AICPA audit or accounting guide or auditing interpretation, the auditor should consider the guidance in SAS No. 1, section 544, *Lack of Conformity With Generally Accepted Accounting Principles*.

<sup>5</sup> For guidance on dating the auditor's report, see SAS No. 1, section 530, *Dating of the Independent Auditor's Report*.



obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed or permitted by the Insurance Department of [State], which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and for filing with the [name of regulatory agency] and should not be used for any other purpose.

## Financial Statements Prepared on the Entity's Income Tax Basis

### Independent Auditor's Report

We have audited the accompanying statements of assets, liabilities, and capital—income tax basis of ABC Partnership as of December 31, 19X2 and 19X1, and the related statements of revenue and expenses—income tax basis and of changes in partners' capital accounts—income tax basis for the years then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of [at] December 31, 19X2 and 19X1, and its revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note X.

## Financial Statements Prepared on the Cash Basis

### Independent Auditor's Report

We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X2 and 19X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

### **Evaluating the Adequacy of Disclosure in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting**

**.09** When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as he or she does to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, paragraph .04.

**.10** Financial statements prepared on an other comprehensive basis of accounting should include, in the accompanying notes, a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from generally accepted accounting principles. However, the effects of the differences between generally accepted accounting principles and the basis of presentation of the financial statements that the auditor is reporting on need not be quantified. In addition, when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate. For example, financial statements prepared on an income tax basis or a modified cash basis of accounting usually reflect depreciation, long-term debt and owners' equity. Thus, the informative disclosures for depreciation, long-term debt and owners' equity in such financial statements should be comparable to those in financial statements prepared in conformity with generally accepted accounting principles. When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (a) related party transactions, (b) restrictions on assets and owners' equity, (c) subsequent events, and (d) uncertainties.

## Specified Elements, Accounts, or Items of a Financial Statement

.11 An independent auditor may be requested to express an opinion on one or more specified elements, accounts, or items of a financial statement. In such an engagement, the specified element(s), account(s), or item(s) may be presented in the report or in a document accompanying the report. Examples of one or more specified elements, accounts, or items of a financial statement that an auditor may report on based on an audit made in accordance with generally accepted auditing standards include rentals, royalties, a profit participation, or a provision for income taxes.<sup>6</sup>

.12 When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor should plan and perform the audit and prepare his or her report with a view to the purpose of the engagement. With the exception of the first standard of reporting, the ten generally accepted auditing standards are applicable to any engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement. The first standard of reporting, which requires that the auditor's report state whether the financial statements are presented in conformity with generally accepted accounting principles, is applicable only when the specified elements, accounts, or items of a financial statement are intended to be presented in conformity with generally accepted accounting principles.

.13 An engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement may be undertaken as a separate engagement or in conjunction with an audit of financial statements. In either case, an auditor expresses an opinion on each of the specified elements, accounts, or items encompassed by the auditor's report; therefore, the measurement of materiality must be related to each individual element, account, or item reported on rather than to the aggregate thereof or to the financial statements taken as a whole. Consequently, an audit of a specified element, account, or item for purposes of reporting thereon is usually more extensive than if the same information were being considered in conjunction with an audit of financial statements taken as a whole. Also, many financial statement elements are interrelated, for example, sales and receivables; inventory and payables; and buildings and equipment and depreciation. The auditor should be satisfied that elements, accounts, or items that are interrelated with those on which he or she has been engaged to express an opinion have been considered in expressing an opinion.

.14 The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (see section 508, *Reports on Audited Financial Statements*, paragraph .73). However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements,

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<sup>6</sup> See section 622, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, for guidance when reporting on the results of applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement and Statements on Standards for Attestation Engagements, *Attestation Standards* (AT section 100), for guidance when reporting on a review of one or more specified elements, accounts or items of a financial statement.

accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

### **Reports on One or More Specified Elements, Accounts, or Items of a Financial Statement**

.15 When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include—

- a. A title that includes the word *independent*.<sup>7</sup>
- b. A paragraph that—
  - (1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account or item.
  - (2) States that the specified elements, accounts, or items are the responsibility of the Company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts or items based on the audit.
- c. A paragraph that—
  - (1) States that the audit was conducted in accordance with generally accepted auditing standards.
  - (2) States that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the specified elements, accounts, or items are free of material misstatement.
  - (3) States that an audit includes—
    - (a) Examining, on a test basis, evidence supporting the amounts and disclosures in the presentation of the specified elements, accounts, or items,
    - (b) Assessing the accounting principles used and significant estimates made by management, and
    - (c) Evaluating the overall presentation of the specified elements, accounts, or items.
  - (4) States that the auditor believes that his or her audit provides a reasonable basis for the auditor's opinion.
- d. A paragraph<sup>8</sup> that—
  - (1) Describes the basis on which the specified elements, accounts, or items are presented (see paragraph .09 and .10) and, when applicable, any agreements specifying such

<sup>7</sup> See footnote 1.

<sup>8</sup> Alternatively, this requirement can be met by incorporating the description in the introductory paragraph discussed in paragraph .15b above.

basis if the presentation is not prepared in conformity with generally accepted accounting principles.<sup>9</sup>

- (2) If considered necessary, includes a description and the source of significant interpretations, if any, made by the Company's management, relating to the provisions of a relevant agreement.
- e. A paragraph that expresses the auditor's opinion (or disclaims an opinion) on whether the specified elements, accounts, or items are fairly presented, in all material respects, in conformity with the basis of accounting described. If the auditor concludes that the specified elements, accounts, or items are not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, the auditor should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph appropriate modifying language and a reference to such explanatory paragraph(s).<sup>10</sup>
- f. If the specified element, account, or item is prepared to comply with the requirements or financial reporting provisions of a contract or agreement that results in a presentation that is not in conformity with either generally accepted accounting principles or an other comprehensive basis of accounting, a paragraph that restricts the distribution of the report to those within the entity and the parties to the contract or agreement.<sup>11</sup> Such a restriction is necessary because the basis of presentation is determined by reference to a document that would not generally be available to other third parties.
- g. The manual or printed signature of the auditor's firm.
- h. The date.<sup>12</sup>

When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor, to provide more information as to the scope of the audit, may wish to describe in a separate paragraph certain other auditing procedures applied. However, no modification in the content of paragraph .15c above should be made.

**.16** If a specified element, account, or item is, or is based upon, an entity's net income or stockholders' equity or the equivalent thereof, the auditor should have audited the complete financial statements to express an opinion on the specified element, account, or item.

**.17** The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in section 508, *Reports on Audited Financial Statements*, paragraph .11, from the standard report on the audited financial statements might have on the report on a specified element, account, or item thereof.

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<sup>9</sup> When the specified element, account or item is presented in conformity with another comprehensive basis of accounting, see paragraph .05d(2).

<sup>10</sup> Paragraph .31 discusses other circumstances that may require that the auditor add additional explanatory language to the special report.

<sup>11</sup> If the presentation is prepared on a basis prescribed by a governmental regulatory agency (which is also OCBOA), the auditor should restrict the distribution of the report on such presentation. See paragraph .05f for further reporting guidance in this situation.

<sup>12</sup> See footnote 5.

.18 Following are illustrations of reports expressing an opinion on one or more specified elements, accounts, or items of a financial statement.

### Report Relating to Accounts Receivable

#### Independent Auditor's Report

We have audited the accompanying schedule of accounts receivable of ABC Company as of December 31, 19X2. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of accounts receivable is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of accounts receivable. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of accounts receivable referred to above presents fairly, in all material respects, the accounts receivable of ABC Company as of December 31, 19X2, in conformity with generally accepted accounting principles.<sup>13</sup>

### Report Relating to Amount of Sales for the Purpose of Computing Rental

#### Independent Auditor's Report

We have audited the accompanying schedule of gross sales (as defined in the lease agreement dated March 4, 19XX, between ABC Company, as lessor, and XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 19X2. This schedule is the responsibility of XYZ Stores Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of gross sales is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of gross sales. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of gross sales referred to above presents fairly, in all material respects, the gross sales of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 19X2, as defined in the lease agreement referred to in the first paragraph.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Stores Corporation and ABC Company and should not be used for any other purpose.

### Report Relating to Royalties

#### Independent Auditor's Report

We have audited the accompanying schedule of royalties applicable to engine production of the Q Division of XYZ Corporation for the year ended Decem-

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<sup>13</sup> Since this presentation was prepared in conformity with generally accepted accounting principles, the report need not be restricted.

ber 31, 19X2, under the terms of a license agreement dated May 14, 19XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation's interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 19X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and should not be used for any other purpose.

## Report on a Profit Participation<sup>14</sup>

### Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company for the year ended December 31, 19X1, and have issued our report thereon dated March 10, 19X2. We have also audited XYZ Company's schedule of John Smith's profit participation for the year ended December 31, 19X1. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit of the schedule in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of profit participation is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that the documents that govern the determination of John Smith's profit participation are (a) the employment agreement between John Smith and XYZ Company dated February 1, 19X0, (b) the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 19X0, and (c) the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 19X0, as amended November 1, 19X0.

In our opinion, the schedule of profit participation referred to above presents fairly, in all material respects, John Smith's participation in the profits of XYZ Company for the year ended December 31, 19X1, in accordance with the provisions of the agreements referred to above.

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<sup>14</sup> See paragraph .16.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Company and John Smith and should not be used for any other purpose.

## **Report on Federal and State Income Taxes Included in Financial Statements<sup>15</sup>**

### Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX. We have also audited the current and deferred provision for the Company's federal and state income taxes for the year ended June 30, 19XX, included in those financial statements, and the related asset and liability tax accounts as of June 30, 19XX. This income tax information is the responsibility of the Company's management. Our responsibility is to express an opinion on it based on our audit.

We conducted our audit of the income tax information in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the federal and state income tax accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures related to the federal and state income tax accounts. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the federal and state income tax accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company has paid or, in all material respects, made adequate provision in the financial statements referred to above for the payment of all federal and state income taxes and for related deferred income taxes that could be reasonably estimated at the time of our audit of the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX.

## **Compliance With Aspects of Contractual Agreements or Regulatory Requirements Related to Audited Financial Statements**

.19 Entities may be required by contractual agreements, such as certain bond indentures and loan agreements, or by regulatory agencies to furnish compliance reports by independent auditors.<sup>16</sup> For example, loan agreements often impose on borrowers a variety of obligations involving matters such as payments into sinking funds, payments of interest, maintenance of current ratios, and restrictions of dividend payments. They usually also require the borrower to furnish annual financial statements that have been audited by an independent auditor. In some instances, the lenders or their trustees may request assurance from the independent auditor that the borrower has complied with certain covenants of the agreement relating to accounting matters. The independent auditor may satisfy this request by giving negative assurance relative to the applicable covenants based on the audit of the financial statements. This assurance may be given in a separate report or in one or more paragraphs of the auditor's report accompanying the financial statements.

<sup>15</sup> See paragraph .16.

<sup>16</sup> When the auditor is engaged to test compliance with laws and regulations in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States (Yellow Book), he or she should follow guidance contained in section 801, *Compliance Auditing Applicable to Governmental Entities and Other Specified Recipients of Governmental Financial Assistance*.



Such assurance, however, should not be given unless the auditor has audited the financial statements to which the contractual agreements or regulatory requirements relate and should not extend to covenants that relate to matters that have not been subjected to the audit procedures applied in the audit of the financial statements.<sup>17</sup> In addition, such assurance should not be given if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements to which these covenants relate.

**.20** When an auditor's report on compliance with contractual agreements or regulatory provisions is being given in a separate report, the report should include—

- a. A title that includes the word *independent*.<sup>18</sup>
- b. A paragraph that states the financial statements were audited in accordance with generally accepted auditing standards and that includes the date of the auditor's report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed.
- c. A paragraph that includes a reference to the specific covenants or paragraphs of the agreement, provides negative assurance relative to compliance with the applicable covenants of the agreement insofar as they relate to accounting matters, and specifies that the negative assurance is being given in connection with the audit of the financial statements. The auditor should ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance.
- d. A paragraph that includes a description and the source of significant interpretations, if any, made by the Company's management relating to the provisions of a relevant agreement.
- e. A paragraph that restricts the distribution of the report to those within the entity and the parties to the contract or agreement or for filing with the regulatory agency, since the matters on which the auditor is reporting are set forth in a document that would not generally be available to other third parties.
- f. The manual or printed signature of the auditor's firm.
- g. The date.<sup>19</sup>

**.21** When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, after the opinion paragraph, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph

<sup>17</sup> When the auditor is engaged to provide assurance on compliance with contractual agreements or regulatory provisions that relate to matters that have not been subjected to the audit procedures applied in the audit of the financial statements, the auditor should refer to the guidance in the Statements on Standards for Attestation Engagements, *Attestation Standards*, AT section 100.

<sup>18</sup> See footnote 1.

<sup>19</sup> See footnote 5.

.20d as well as a paragraph that restricts its distribution as discussed in paragraph .20e. Following are examples of reports that might be issued:

### **Report on Compliance With Contractual Provisions Given in a Separate Report <sup>20</sup>**

#### Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the balance sheet of XYZ Company as of December 31, 19X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 19X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 19X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and management of XYZ Company and ABC Bank and should not be used for any other purpose.

### **Report on Compliance With Regulatory Requirements Given in a Separate Report When the Auditor's Report on the Financial Statements Included an Explanatory Paragraph Because of an Uncertainty**

#### Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the balance sheet of XYZ Company as of December 31, 19X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated March 5, 19X3, which included an explanatory paragraph that described the litigation discussed in Note X of those statements.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the accounting provisions in sections (1), (2) and (3) of the [name of state regulatory agency]. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and the [name of state regulatory agency] and should not be used for any other purpose.

### **Special-Purpose Financial Presentations to Comply With Contractual Agreements or Regulatory Provisions**

.22 An auditor is sometimes asked to report on special-purpose financial statements prepared to comply with a contractual agreement<sup>21</sup> or regulatory provisions. In most circumstances, these types of presentations are intended solely for the use of the parties to the agreement, regulatory bodies, or other specified parties. This section discusses reporting on these types of presentations, which include the following:

<sup>20</sup> When the auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the last two paragraphs of this report are examples of the paragraphs that should follow the opinion paragraph of the auditor's report on the financial statements.

<sup>21</sup> A contractual agreement as discussed in this section is an agreement between the client and one or more third parties other than the auditor.

- a. A special-purpose financial presentation prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues and expenses, but is otherwise prepared in conformity with generally accepted accounting principles or an other comprehensive basis of accounting (paragraphs .23 through .26).
- b. A special-purpose financial presentation (may be a complete set of financial statements or a single financial statement) prepared on a basis of accounting prescribed in an agreement that does not result in a presentation in conformity with generally accepted accounting principles or an other comprehensive basis of accounting (paragraphs .27 through .30).

**Financial Statements Prepared on a Basis of Accounting Prescribed in a Contractual Agreement or Regulatory Provision That Results in an Incomplete Presentation But One That is Otherwise in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting**

.23 A governmental agency may require a schedule of gross income and certain expenses of an entity's real estate operation in which income and expenses are measured in conformity with generally accepted accounting principles, but expenses are defined to exclude certain items such as interest, depreciation, and income taxes. Such a schedule may also present the excess of gross income over defined expenses. Also, a buy-sell agreement may specify a schedule of gross assets and liabilities of the entity measured in conformity with generally accepted accounting principles, but limited to the assets to be sold and liabilities to be transferred pursuant to the agreement.

.24 Paragraph .02 of this section defines the term *financial statement* and includes a list of financial presentations that an auditor should consider to be financial statements for reporting purposes. The concept of specified elements, accounts, or items of a financial statement discussed in paragraphs .11 through .18, on the other hand, refers to accounting information that is part of, but significantly less than, a financial statement. The financial presentations described above and similar presentations should generally be regarded as financial statements, even though, as indicated above, certain items may be excluded. Thus, when the auditor is asked to report on these types of presentations, the measurement of materiality for purposes of expressing an opinion should be related to the presentations taken as a whole (see section 312, *Audit Risk and Materiality in Conducting an Audit*). Further, the presentations should differ from complete financial statements only to the extent necessary to meet special purposes for which they were prepared. In addition, when these financial presentations contain items that are the same as, or similar to, those contained in a full set of financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate (see paragraphs .09 and .10). The auditor should also be satisfied that the financial statements presented are suitably titled to avoid any implication that the special-purpose financial statements on which he or she is reporting are intended to present financial position, results of operations, or cash flows.

.25 When the auditor is asked to report on financial statements prepared on a basis of accounting prescribed in a contractual agreement or regulatory provision that results in an incomplete presentation but one that is otherwise

in conformity with generally accepted accounting principles or an other comprehensive basis of accounting, the auditor's report should include—

- a. A title that includes the word *independent*.<sup>22</sup>
- b. A paragraph that—
  - (1) States that the financial statements identified in the report were audited.
  - (2) States that the financial statements are the responsibility of the Company's management<sup>23</sup> and that the auditor is responsible for expressing an opinion on the financial statements based on the audit.<sup>24</sup>
- c. A paragraph that—
  - (1) States that the audit was conducted in accordance with generally accepted auditing standards.
  - (2) States that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
  - (3) States that an audit includes—
    - (a) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,
    - (b) Assessing the accounting principles used and significant estimates made by management, and
    - (c) Evaluating the overall financial statement presentation.
  - (4) States that the auditor believes that the audit provides a reasonable basis for his or her opinion.
- d. A paragraph that—
  - (1) Explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation (see paragraphs .09 and .10).
  - (2) If the basis of presentation is in conformity with generally accepted accounting principles, states that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues and expenses.<sup>25</sup>
- e. A paragraph that expresses the auditor's opinion related to the fair presentation, in all material respects, of the information the presentation is intended to present in conformity with generally accepted accounting principles or another comprehensive basis of accounting. If the auditor concludes that the information the presentation is

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<sup>22</sup> See footnote 1.

<sup>23</sup> Sometimes the auditor's client may not be the person responsible for the financial statements on which the auditor is reporting. For example, when the auditor is engaged by the buyer to report on the seller's financial statements prepared in conformity with a buy-sell agreement, the person responsible for the financial statements may be the seller's management. In this case, the wording of this statement should be changed to clearly identify the party that is responsible for the financial statements reported on.

<sup>24</sup> See footnote 2.

<sup>25</sup> If the basis of presentation is an other comprehensive basis of accounting, the paragraph should state that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles and that it is not intended to be a complete presentation of the entity's assets, liabilities, revenues and expenses on the basis described.

intended to present is not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, the auditor should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph appropriate modifying language and a reference to such explanatory paragraph(s).<sup>26</sup>

- f. A paragraph that restricts the distribution of the report to those within the entity, to the parties to the contract or agreement, for filing with a regulatory agency or to those with whom the entity is negotiating directly. However, a restrictive paragraph is not appropriate when the report and related financial presentation are to be filed with a regulatory agency, such as the Securities and Exchange Commission, and are to be included in a document (such as a prospectus) that is distributed to the general public.
- g. The manual or printed signature of the auditor's firm.
- h. The date.<sup>27</sup>

.26 The following examples illustrate reports expressing an opinion on such special-purpose financial statements:

**Report on a Schedule of Gross Income and Certain Expenses to Meet a Regulatory Requirement and to Be Included in a Document Distributed to the General Public**

Independent Auditor's Report

We have audited the accompanying Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments, City, State (Historical Summaries), for each of the three years in the period ended December 31, 19XX. These Historical Summaries are the responsibility of the Apartments' management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Historical Summaries are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Historical Summaries. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Historical Summaries. We believe that our audits provide a reasonable basis for our opinion.

The accompanying Historical Summaries were prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF Corporation) as described in Note X and are not intended to be a complete presentation of the Apartments' revenues and expenses.

In our opinion, the Historical Summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 19XX, in conformity with generally accepted accounting principles.

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<sup>26</sup> Paragraph .31 discusses other circumstances that may require that the auditor add additional explanatory language to the special report.

<sup>27</sup> See footnote 5.

## Report on a Statement of Assets Sold and Liabilities Transferred to Comply With a Contractual Agreement

### Independent Auditor's Report

We have audited the accompanying statement of net assets sold of ABC Company as of June 8, 19XX. This statement of net assets sold is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the statement of net assets sold based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement of net assets sold is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statement of net assets sold. We believe that our audit provides a reasonable basis for our opinion.

The accompanying statement was prepared to present the net assets of ABC Company sold to XYZ Corporation pursuant to the purchase agreement described in Note X, and is not intended to be a complete presentation of ABC Company's assets and liabilities.

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 19XX sold pursuant to the purchase agreement referred to in Note X, in conformity with generally accepted accounting principles.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and should not be used for any other purpose.

## **Financial Statements Prepared on a Basis of Accounting Prescribed in an Agreement That Results in a Presentation That is not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting**

.27 The auditor may be asked to report on special-purpose financial statements prepared in conformity with a basis of accounting that departs from generally accepted accounting principles or an other comprehensive basis of accounting. A loan agreement, for example, may require the borrower to prepare consolidated financial statements in which assets, such as inventory, are presented on a basis that is not in conformity with generally accepted accounting principles or an other comprehensive basis of accounting. An acquisition agreement may require the financial statements of the entity being acquired (or a segment of it) to be prepared in conformity with generally accepted accounting principles except for certain assets, such as receivables, inventories, and properties for which a valuation basis is specified in the agreement.

.28 Financial statements prepared under a basis of accounting as discussed above are not considered to be prepared in conformity with a "comprehensive basis of accounting" as contemplated by paragraph .04 of this section because the criteria used to prepare such financial statements do not meet the requirement of being "criteria having substantial support," even though the criteria are definite.

.29 When an auditor is asked to report on these types of financial presentations, the report should include—

- a. A title that includes the word *independent*.<sup>28</sup>
- b. A paragraph that—
  - (1) States that the special-purpose financial statements identified in the report were audited.
  - (2) States that the financial statements are the responsibility of the Company's management<sup>29</sup> and that the auditor is responsible for expressing an opinion on the financial statements based on the audit.<sup>30</sup>
- c. A paragraph that—
  - (1) States that the audit was conducted in accordance with generally accepted auditing standards.
  - (2) States that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
  - (3) States that an audit includes—
    - (a) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,
    - (b) Assessing the accounting principles used and significant estimates made by management, and
    - (c) Evaluating the overall financial statement presentation.
  - (4) States that the auditor believes that the audit provides a reasonable basis for the auditor's opinion.
- d. A paragraph that—
  - (1) Explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation (see paragraphs .09 and .10).
  - (2) States that the presentation is not intended to be a presentation in conformity with generally accepted accounting principles.
- e. A paragraph that includes a description and the source of significant interpretations, if any, made by the Company's management relating to the provisions of a relevant agreement.
- f. A paragraph that expresses the auditor's opinion related to the fair presentation, in all material respects, of the information the presentation is intended to present on the basis of accounting specified. If the auditor concludes that the information the presentation is intended to present is not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, the auditor should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion para-

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<sup>28</sup> See footnote 1.

<sup>29</sup> See footnote 23.

<sup>30</sup> See footnote 2.

graph appropriate modifying language and a reference to such explanatory paragraph(s).<sup>31</sup>

- g.* A paragraph that restricts the distribution of the report to those within the entity, the parties to the contract or agreement, for filing with a regulatory agency, or to those with whom the entity is negotiating directly. For example, when the financial statements have been prepared for the specified purpose of obtaining bank financing, the restriction should limit distribution to the various banks with whom the entity is negotiating the proposed financing.
- h.* The manual or printed signature of the auditor's firm.
- i.* The date.<sup>32</sup>

.30 The following example illustrates reporting on special-purpose financial statements that have been prepared pursuant to a loan agreement:

**Report on Financial Statements Prepared Pursuant to a Loan Agreement That Results in a Presentation not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting**

Independent Auditor's Report

We have audited the special-purpose statement of assets and liabilities of ABC Company as of December 31, 19X2 and 19X1, and the related special-purpose statements of revenues and expenses and of cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with Section 4 of a loan agreement between DEF Bank and the Company as discussed in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the special-purpose financial statements referred to above present fairly, in all material respects, the assets and liabilities of ABC Company at December 31, 19X2 and 19X1, and the revenues, expenses and cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the boards of directors and management of ABC Company and DEF Bank and should not be used for any other purpose.

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<sup>31</sup> Paragraph .31 discusses other circumstances that may require that the auditor add additional explanatory language to the special report.

<sup>32</sup> See footnote 5.



## Circumstances Requiring Explanatory Language in an Auditor's Special Report

.31 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

- a. *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application,<sup>33</sup> the auditor should add an explanatory paragraph to the report (following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts or items thereof) that discusses the change and its effect thereon<sup>34</sup> if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in section 508, *Reports on Audited Financial Statements*, paragraphs .34 through .36.
- b. *Uncertainties.* If the financial presentations (or specified elements, accounts, or items thereof) are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditor's report, the auditor should add an explanatory paragraph after the opinion paragraph<sup>35</sup> if the uncertainties are considered relevant to the presentation.<sup>36</sup> For example, if the auditor is reporting on compliance with specific provisions of a loan agreement or on the fair presentation, in conformity with a specified basis of accounting, of a schedule related to a specific aspect of an entity's operations (such as a schedule of product royalties), an explanatory paragraph highlighting the material uncertainty arising from a lawsuit may not be necessary if the uncertainty is not relevant to the presentation. In contrast, such an explanatory paragraph would be necessary in a report on an entity's financial statements prepared on the cash basis because the uncertainty would be relevant.
- c. *Going Concern Uncertainties.* If the auditor has substantial doubt about the entity's ability to continue as a going concern for a

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<sup>33</sup> When financial statements (or specified elements, accounts, or items thereof) have been prepared in conformity with generally accepted accounting principles in prior years, and the entity changes its method of presentation in the current year by preparing its financial statements in conformity with another comprehensive basis of accounting, the auditor need not follow the reporting guidance in this subparagraph. However, the auditor may wish to add an explanatory paragraph to the report to highlight (1) a difference in the basis of presentation from that used in prior years or (2) that another report has been issued on the entity's financial statements prepared in conformity with another basis of presentation (for example, when cash basis financial statements are issued in addition to GAAP financial statements).

<sup>34</sup> A change in the tax law is not considered to be a change in accounting principle for which the auditor would need to add an explanatory paragraph, although disclosure may be necessary.

<sup>35</sup> The addition of an explanatory paragraph to the auditor's report to identify an uncertainty, as contemplated by this section, serves adequately to inform users of the financial statements (or specified elements, accounts or items thereof). Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and the possible effects on the financial statements (or specified elements, accounts, or items thereof) should be disclosed in an appropriate manner, and the auditor's report should give all the substantive reasons for his or her disclaimer of opinion.

<sup>36</sup> The auditor should consider the guidance in section 508, *Reports on Audited Financial Statements*, paragraphs .16 through .33, on addressing and evaluating material uncertainties.

reasonable period of time not to exceed one year beyond the date of the financial statement, the auditor should add an explanatory paragraph after the opinion paragraph of the report only if the auditor's substantial doubt is relevant to the presentation.<sup>37</sup>

- d. *Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in section 508, *Reports on Audited Financial Statements*, paragraphs .12 and .13.
- e. *Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof).* If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph of the report. Guidance on reporting in this situation is contained in section 508, *Reports on Audited Financial Statements*, paragraphs .77 and .78.

As in reports on financial statements prepared in conformity with generally accepted accounting principles, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (or specified elements, accounts, or items thereof).

## Financial Information Presented in Prescribed Forms or Schedules

.32 Printed forms or schedules designed or adopted by the bodies with which they are to be filed often prescribe the wording of an auditor's report. Many of these forms are not acceptable to independent auditors because the prescribed form of auditor's report does not conform to the applicable professional reporting standards. For example, the prescribed language of the report may call for statements by the auditor that are not consistent with the auditor's function or responsibility.

.33 Some report forms can be made acceptable by inserting additional wording; others can be made acceptable only by complete revision. When a printed report form calls upon an independent auditor to make a statement that he or she is not justified in making, the auditor should reword the form or attach a separate report. In those situations, the reporting provisions of paragraph .05 may be appropriate.

## Effective Date

.34 This section is effective for reports issued on or after July 1, 1989. Early application of the provisions of this section is permissible.

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[The next page is 1101.]

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<sup>37</sup> See section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, for a report example when the auditor has substantial doubt about the entity's ability to continue as a going concern. (Also, see footnote 35.)

## AU Section 9623

### ***Special Reports: Auditing Interpretations of Section 623***

**[1.] Auditor's Report Under Employee Retirement Income Security Act of 1974**

[.01—.08] [Withdrawn February, 1983.\*]

**[2.] Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity with GAAP**

[.09—.10] [Withdrawn March, 1989, by SAS No. 62. (See section 623.)]

**[3.] Compliance with the Foreign Corrupt Practices Act of 1977**

[.11—.14] [Transferred to AU section 9642.]

**[4.] Reports on Engagements Solely to Meet State Regulatory Examination Requirements**

[.15—.16] [Deleted April, 1981 by SAS No. 35.] (See section 622.)

**[5.] Financial Statements Prepared in Accordance with Accounting Practices Specified in an Agreement**

[.17—.25] [Withdrawn March, 1989, by SAS No. 62. (See section 623.)]

**[6.] Reporting on Special-Purpose Financial Presentations** <sup>[3]. [4]</sup>

[.26—.31] [Withdrawn March, 1989, by SAS No. 62. (See section 623.)]

**[7.] Understanding of Agreed-Upon Procedures**

[.32—.33] [Deleted April, 1981 by SAS No. 35.] (See section 622.)

**[8.] Adequacy of Disclosure in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles**

[.34—.39] [Withdrawn March, 1989, by SAS No. 62. (See section 623.)]

**9. Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves**

**.40 Question**—The instructions to the statutory annual statement to be filed by property and liability insurance companies with state regulatory agencies include the following:

If a company is required by its domiciliary commissioner, there is to be submitted to the commissioner as an addendum to the Annual Statement by April 1 of the subsequent year a statement of a qualified loss reserve specialist setting forth his or her opinion relating to loss and loss adjustment expense reserves.

The term "qualified loss reserve specialist" includes an independent auditor who has competency in loss reserve evaluation.

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\* See Audit and Accounting Guide, *Audits of Employee Benefit Plans*, February, 1983.

<sup>[3]</sup> [Footnote deleted.]

<sup>[4]</sup> [Footnote deleted.]

.41 If an independent auditor who has made an audit of the insurance company's financial statements in accordance with generally accepted auditing standards is engaged to express a separate opinion on the company's loss and loss adjustment expense reserves for the purpose of compliance with the above instruction, what form of report should be used by the independent auditor?

.42 *Interpretation*—Section 623.11—.18 provides guidance on auditors' reports expressing an opinion on one or more specified elements, accounts, or items of a financial statement. Following are illustrations of the auditor's report expressing an opinion on a company's loss and loss adjustment expense reserves and the schedule of liabilities for losses and loss adjustment expenses that would accompany the report.<sup>5</sup>

### Illustrative report

Board of Directors

X Insurance Company

We are members of the American Institute of Certified Public Accountants (AICPA) and are the independent public accountants of X Insurance Company. We acknowledge our responsibility under the AICPA's Code of Professional Conduct to undertake only those engagements which we can complete with professional competence.

We have audited the financial statements prepared in conformity with generally accepted accounting principles [or prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of .....] of X Insurance Company as of December 31, 19X0, and have issued our report thereon dated March 1, 19X1. In the course of our examination, we have examined the estimated liabilities for unpaid losses and unpaid loss adjustment expenses of X Insurance Company as of December 31, 19X0, as set forth in the accompanying schedule including consideration of the assumptions and methods relating to the estimation of such liabilities.

In our opinion, the accompanying schedule presents fairly, in all material respects, the estimated unpaid losses and unpaid loss adjustment expenses of X Insurance Company that could be reasonably estimated at December 31, 19X0, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ..... on a basis consistent with that of the preceding year.

This report is intended solely for filing with regulatory agencies and is not intended for any other purpose.

Signature

Date

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<sup>5</sup> If a significant period of time has elapsed between the date of report on the financial statements and the date he is reporting on the loss and loss adjustment expense reserves, the auditor may wish to include the following paragraph in his special report: Because we have not audited any financial statements of X Insurance Company as of any date or for any period subsequent to December 31, 19X0, we have no knowledge of the effects, if any, on the liability for unpaid losses and unpaid loss adjustment expenses of events that may have occurred subsequent to the date of our audit.

**X Insurance Company****Schedule of Liabilities for Losses****and Loss Adjustment Expenses****December 31, 19X0**

Liability for losses	\$xx,xxx,xxx
Liability for loss adjustment expenses	x,xxx,xxx
Total	<u>\$xx,xxx,xxx</u>

**Note 1—Basis of presentation**

The above schedule has been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ..... (Significant differences between statutory practices and generally accepted accounting principles for the calculation of the above amounts should be described but the monetary effect of any such differences need not be stated.)

Losses and loss adjustment expenses are provided for when incurred in accordance with the applicable requirements of the insurance laws [and/or regulations] of the State of ..... Such provisions include (1) individual case estimates for reported losses, (2) estimates received from other insurers with respect to reinsurance assumed, (3) estimates for unreported losses based on past experience modified for current trends, and (4) estimates of expenses for investigating and settling claims.

**Note 2—Reinsurance**

The Company reinsures certain portions of its liability insurance coverages to limit the amount of loss on individual claims and purchases catastrophe insurance to protect against aggregate single occurrence losses. Certain portions of property insurance are reinsured on a quota share basis.

The liability for losses and the liability for loss adjustment expenses were reduced by \$xxx,xxx and \$xxx,xxx, respectively, for reinsurance ceded to other companies.

Contingent liability exists with respect to reinsurance which would become an actual liability in the event the reinsuring companies, or any of them, might be unable to meet their obligations to the Company under existing reinsurance agreements.

**.43 Question**—The instructions to the statutory annual statement also include the following:

If there has been any material change in the assumptions and/or methods from those previously employed, that change should be described in the statement of opinion by inserting a phrase such as:

A material change in assumptions (and/or methods) was made during the past year, but such change accords with accepted loss reserving standards.

A brief description of the change should follow.

**.44** In what circumstances is it appropriate for the independent auditor to modify his special report on loss and loss adjustment expense reserves for material changes in assumptions and/or methods?

**.45 Interpretation**—Section 420.06 states that changes in accounting principles and methods of applying them affect consistency and require the addition of an explanatory paragraph (following the opinion paragraph) in the auditor's report on the audited financial statements. Section 623.15 states that, if applicable, any departures from the auditor's standard report on the related financial statements should be indicated in the special report on an element, account, or item of a financial statement.

**.46** Section 420.13 states that a change in accounting estimate is not a change affecting consistency requiring recognition in the auditor's report. However, such changes in estimates that are disclosed in the financial statements on which the auditor has reported should also be disclosed in the notes to the schedule of liabilities for unpaid losses and unpaid loss adjustment expenses accompanying the auditor's special report. (See APB Opinion No. 20, *Accounting Changes*, paragraph 33 [AC section A06.132].)

[Issue Date: May, 1981.]

## **10. Reports on the Financial Statements Included in Internal Revenue Form 990, "Return of Organizations Exempt from Income Tax"**

**.47 Question**—Internal Revenue Form 990, "Return of Organizations Exempt from Income Tax," may be used as a uniform annual report by charitable organizations in some states for reporting to both state and federal governments. Many states require an auditor's opinion on whether the financial statements included in the report <sup>6</sup> are presented fairly in conformity with generally accepted accounting principles. Ordinarily, financial statements included in a Form 990 used by a charitable organization as a uniform annual report may be expected to contain certain material departures from the accounting principles in the AICPA industry audit guides, "Audits of Colleges and Universities," "Hospital Audit Guide," "Audits of Voluntary Health and Welfare Organizations," and AICPA Statement of Position 78-10, "Accounting Principles and Reporting Practices for Certain Nonprofit Organizations."

**.48** In most states the report is used primarily to satisfy statutory requirements, but regulatory authorities make the financial statements and the accompanying auditor's report a matter of public record. In some situations, however, there may be public distribution of the report. What should be the form of the auditor's report in each of the above situations?

**.49 Interpretation**—In both situations, the auditor should first consider whether the financial statements (including appropriate notes to financial statements) are in conformity with generally accepted accounting principles. If they are, the auditor can express an unqualified opinion.

**.50** If the financial statements are not in conformity with generally accepted accounting principles, the auditor should consider the distribution of the report to determine whether it is appropriate to issue a special report (as illustrated in section 623, *Special Reports*, paragraph .08, for reporting on

<sup>6</sup> As used in this interpretation, the report refers to a Form 990 report by a charitable organization in a filing with a government agency.

financial statements prepared in accordance with the requirements or financial reporting provisions of a government regulatory agency).

.51 Section 623 permits this type of special report only if the financial statements are intended solely for filing with a regulatory agency or if additional distribution is recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation. However, section 623 makes this form of reporting appropriate, even though by law or regulation the accountant's report may be made a matter of public record.<sup>7</sup>

.52 The following example illustrates a report expressing an opinion on such special purpose financial statements:

Independent Auditor's Report

We have audited the balance sheet (Part V) of XYZ Charity as of December 31, 19XX, and the related statement of support, revenue and expenses and changes in fund balances (Part I) and statement of functional expenses (Part II) for the year then ended included in the accompanying Internal Revenue Service Form 990. These financial statements are the responsibility of Charity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed by the Internal Revenue Service and the Office of the State of ....., which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities and fund balances of XYZ Charity as of December 31, 19XX and its support, revenue and expenses and changes in fund balances for the year then ended on the basis of accounting described in Note X.<sup>[8]</sup>

Our audit was made for the purpose of forming an opinion on the above financial statements taken as a whole. The accompanying information on pages ..... to ..... is presented for purposes of additional analysis and is not a required part of the above financial statements. Such information, except for that portion marked

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<sup>7</sup> *Public record*, for purposes of auditors' reports in state with exempt organizations, includes circumstances in which specific requests must be made by the public to obtain access to or copies of the report, notwithstanding the fact that some states may advertise or require the exempt organization to advertise the availability of Form 990. In contrast, *public distribution*, for purposes of auditors' reports in state filings on various Forms 990 dealing with exempt organizations, includes circumstances in which the regulatory agency or the exempt organization, either because of regulatory requirements or voluntarily, distributes copies of Form 990 to contributors or others without receiving a specific request for such distribution.

<sup>[8]</sup> [Footnote deleted.]

“unaudited,” on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the above financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the financial statements taken as a whole.

This report is intended solely for the information and use of the board of directors and management of XYZ Charity and for filing with the Internal Revenue Service and the Office of the State of ..... and should not be used for any other purpose.

[Signature]

[Date]

.53 If there is public distribution<sup>9</sup> of the report, because the law requires it or otherwise (copies of Form 990 are distributed to contributors or others without receiving a specific request for such distribution) and the financial statements included in it are not in conformity with generally accepted accounting principles, a special report (as illustrated in section 623.08) is not appropriate. In such cases, the auditor should express a qualified or adverse opinion and disclose the effects on the financial statements of the departures from generally accepted accounting principles if the effects are reasonably determinable. If the effects are not reasonably determinable, the report should so state.

.54 Uniform generally accepted accounting principles for nonprofit organizations, including those filing Form 990, are still in the developmental stage. Therefore, auditors should recognize that the use of a special purpose report on Form 990 is only an interim solution until the reporting issues have been resolved by the Financial Accounting Standards Board.

[Issue Date: July, 1982.]

## **11. Reporting on Current-Value Financial Statements That Supplement Historical-Cost Financial Statements in a General-Use Presentation of Real Estate Entities**

.55 *Question*—A real estate entity presents current-value financial statements<sup>10</sup> to supplement historical-cost financial statements in a general-use presentation. When engaged to report on these current-value financial statements, how should an auditor report?

.56 *Interpretation*—An auditor should accept an engagement to report on current-value financial statements that supplement historical-cost financial statements in a general-use presentation of a real estate entity only if the auditor believes the following two conditions exist—

- the measurement and disclosure criteria used to prepare the current-value financial statements are reasonable, and

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<sup>9</sup> Auditors should consider whether there is a public distribution requirement by reference to the relevant state law. However, at this time (April 1982), most state laws do not contain a public distribution requirement and a special report is ordinarily appropriate. For example, the laws of New York, New Jersey and Connecticut do not presently require public distribution as defined by this interpretation.

<sup>10</sup> Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in section 508, *Reports on Audited Financial Statements*, and the applicable industry audit guide.



- competent persons using the measurement and disclosure criteria would ordinarily obtain materially similar measurements or disclosures.

.57 If these conditions are satisfied, an auditor may report on such current-value financial statements in a manner similar to that discussed in section 623, *Special Reports*, paragraph .29. However, because the current-value financial statements only supplement the historical-cost financial statements and are not presented as a stand-alone presentation, it is not necessary to restrict the distribution of the auditor's report on the presentation as required by that paragraph.

.58 The following is an example of a report an auditor might issue when reporting on current-value financial statements that supplement historical-cost financial statements in a general-use presentation of a real estate entity:

Independent Auditor's Report

We have audited the accompanying historical-cost balance sheets of X Company as of December 31, 19X3 and 19X2, and the related historical-cost statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 19X3. We also have audited the supplemental current-value balance sheets of X Company as of December 31, 19X3 and 19X2, and the related supplemental current-value statements of income and shareholders' equity for each of the three years in the period ended December 31, 19X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the historical-cost financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X3 and 19X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 19X3, in conformity with generally accepted accounting principles.

As described in note 1, the supplemental current-value financial statements have been prepared by management to present relevant financial information that is not provided by the historical-cost financial statements and are not intended to be a presentation in conformity with generally accepted accounting principles. In addition, the supplemental current-value financial statements do not purport to present the net realizable, liquidation, or market value of the Company as a whole. Furthermore, amounts ultimately realized by the Company from the disposal of properties may vary significantly from the current values presented.

[The next page is 1107-3.]

In our opinion, the supplemental current-value financial statements referred to above present fairly, in all material respects, the information set forth in them on the basis of accounting described in note 1.

[Signature]

[Date]

.59 The auditor should also consider the adequacy of disclosures relating to the current value financial statements. Such disclosures should describe the accounting policies applied and such matters as the basis of presentation, nature of the reporting entity's properties, status of construction-in-process, valuation bases used for each classification of assets and liabilities, and sources of valuation. These matters should be disclosed in the notes in a sufficiently clear and comprehensive manner that enables a knowledgeable reader to understand the current-value financial statements.

[Issue Date: July, 1990.]

## **12. Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis**

.60 *Question*—Insurance enterprises issue financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators (a "statutory basis") in addition to, or instead of, financial statements prepared in accordance with generally accepted accounting principles (GAAP). How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate?

.61 *Interpretation*—Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to section 623, *Special Reports*, paragraph .04. Section 623.09 states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as he or she does to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, paragraph .04."

.62 Section 623.02 states that generally accepted auditing standards apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Thus, in accordance with the third standard of reporting, "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

.63 *Question*—What types of items or matters should auditors consider in evaluating whether informative disclosures are reasonably adequate?

**.64 Interpretation**—Section 623.09 and .10 indicates that financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used, including a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. Section 623.10 also states that when “the financial statements [prepared on an other comprehensive basis of accounting] contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate.”

**.65** In addition, in 1991, the National Association of Insurance Commissioners (NAIC) adopted a new Annual Statement instruction, *Annual Audited Financial Reports*, under which insurance enterprises are required to include in their statutory basis financial statements those disclosures that “are appropriate to a CPA audited financial report, based on applicability, materiality and significance, taking into account the subjects covered in the instructions to and illustrations of how to report information in the notes to the financial statements section of [the] Annual Statement instructions and any other notes required by generally accepted accounting principles. . . .” The laws and regulations of some individual states contain similar requirements.

**.66** Therefore, the auditor should also consider the disclosures and illustrations of how to report information in the notes to financial statements section of the Annual Statement instructions.

**.67 Question**—How does the auditor evaluate whether “similar informative disclosures” are appropriate for—

- a. Items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP
- b. Items and transactions that are accounted for differently under a statutory basis than under GAAP

**.68 Interpretation**—Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP should be the same as, or similar to, the disclosures required by GAAP. Other disclosures considered necessary upon review of the Annual Statement instructions should also be made to the extent that such disclosures are significant to the statutory basis financial statements.

**.69** For example, disclosures in statutory basis financial statements concerning financial instruments should include the applicable disclosures required by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* [AC section In6], FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* [AC section F25], and AICPA Statement of Position 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*.

**.70** Disclosures in statutory basis financial statements for items that are accounted for differently under a statutory basis than under GAAP should be the same as the disclosures required by GAAP that are relevant to the statutory basis of accounting for that item. Such disclosures can be separated into two general categories, which are discussed in paragraphs .71—.76 of this Interpretation. The examples presented are for illustrative purposes only and are not intended to be all-inclusive.

.71 Specific disclosures are stated in GAAP literature for the accounting method used in the statutory basis financial statements, even though the item would be accounted for differently under GAAP. In such instances, the applicable GAAP disclosures should be made in addition to those disclosures considered necessary upon review of the Annual Statement instructions.

.72 For example, certain leases entered into by a lessee insurance enterprise that would be accounted for as capital leases under GAAP are accounted for as operating leases by insurance enterprises in their statutory basis financial statements. In such instances, the applicable disclosures for operating leases required by FASB Statement No. 13, *Accounting for Leases* [AC section L10], should be made in the statutory basis financial statements.

.73 Another example is reinsurance transactions. Certain reinsurance contracts are permitted to be accounted for as reinsurance transactions in statutory basis financial statements but would be accounted for as financing transactions under GAAP. In such instances, the applicable disclosures for the contracts accounted for as reinsurance transactions that are required by FASB Statement No. 60 [AC section In6] should be made in statutory basis financial statements.

.74 Specific disclosures are not stated in current GAAP literature for the accounting method used in the statutory basis financial statements. If statutory accounting principles (SAP) permit insurance enterprises to use an accounting method that has been superseded under GAAP literature, disclosures that were required under the superseded GAAP literature should be made.

.75 For example, some insurance companies are permitted to account for pensions in their statutory basis financial statements using the same method as required under APB Opinion No. 8, *Accounting for the Cost of Pension Plans*, which was amended by FASB Statement No. 36, *Disclosure of Pension Information*. (APB Opinion No. 8 and FASB Statement No. 36 were superseded by FASB Statement No. 87, *Employers' Accounting for Pensions* [AC section P16], for fiscal years that began after December 15, 1986.) In addition to disclosing the accounting policy for pensions, insurance companies should make the disclosures contained in APB Opinion No. 8 and FASB Statement No. 36 in their statutory basis financial statements. If a company is accounting for pensions using another method of measurement, such as tax, it should make informative disclosures, at a minimum, such as type of benefit formula, funding policy, fair value of plan assets, and amount of pension costs.

.76 A final example is deferred acquisition costs (DAC). Acquisition costs are expensed when paid under SAP and are capitalized and amortized under GAAP. FASB Statement No. 60 [AC section In6] requires certain disclosures about DAC—the nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period. Because DAC are not capitalized under SAP, such disclosures, other than a description of the accounting policy used, are unapplicable.

.77 When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (a) related party transactions, (b) restrictions on assets and owners' equity, (c) subsequent events, and (d) uncertainties. Other matters should be disclosed if such disclosures are necessary to keep the financial statements from being misleading.

.78 *Question*—Financial statements of insurance enterprises that are prepared on a statutory basis are considered to be financial statements prepared on a “comprehensive basis of accounting other than GAAP.” For

mutual life insurance enterprises, however, financial statements prepared on a statutory basis are considered, in practice, to be prepared in accordance with GAAP. Should auditors follow the guidance contained in this Interpretation concerning disclosures when reporting on financial statements issued by mutual life insurance enterprises?

**.79 Interpretation**—Yes. Auditors should apply the guidance outlined in this Interpretation concerning disclosures when reporting on financial statements of mutual life insurance enterprises, whether such financial statements are for filing with regulators or for general purpose distribution.

[Issue Date: February, 1992.]

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## AU Section 625

# ***Reports on the Application of Accounting Principles***

Source: SAS No. 50.

Issue date, unless otherwise indicated: July, 1986.

.01 Accounting principles evolve in response to changing economic conditions and to new transactions and financial products.<sup>1</sup> Agreement frequently does not exist about how accounting principles should be applied to those transactions and products. Management, accountants, and intermediaries often consult with professionals, including other accountants, on the application of accounting principles to those transactions and products or to increase their knowledge of specific financial reporting issues.<sup>2</sup> Such consultations are often useful because they may provide information and insights not otherwise available.

## **Applicability**

.02 This section provides guidance that an accountant in public practice ("reporting accountant"), either in connection with a proposal to obtain a new client or otherwise, should apply<sup>3</sup>—

- a. When preparing a written report on the application of accounting principles to specified transactions, either completed or proposed ("specific transactions").
- b. When requested to provide a written report on the type of opinion that may be rendered on a specific entity's financial statements.
- c. When preparing a written report to intermediaries on the application of accounting principles not involving facts or circumstances of a particular principal ("hypothetical transactions").

This section also applies to oral advice on the application of accounting principles to a specific transaction, or the type of opinion that may be rendered on an entity's financial statements, when the reporting accountant concludes the advice is intended to be used by a principal to the transaction as an important factor considered in reaching a decision.

.03 This section does not apply to an accountant ("continuing accountant") who has been engaged to report on financial statements, to engagements either to assist in litigation involving accounting matters or to provide expert testimony in connection with such litigation, or to professional advice given to another accountant in public practice.

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<sup>1</sup> Accounting principles include generally accepted accounting principles and other comprehensive bases of accounting. See section 623, *Special Reports*, paragraph .04 for a description of other comprehensive bases of accounting.

<sup>2</sup> "Intermediaries" refers to those parties who may advise one or more principals to a transaction, and may include, but are not limited to, attorneys and investment, merchant, and commercial bankers.

<sup>3</sup> See ET section 92.09 of the AICPA Code of Professional Conduct for a definition of "practice of public accounting."

.04 This section also does not apply to communications such as position papers prepared by an accountant for the purpose of presenting views on an issue involving the application of accounting principles or the type of opinion that may be rendered on an entity's financial statements. Position papers include newsletters, articles, speeches and texts thereof, lectures and other forms of public presentations, and letters for the public record to professional and governmental standard-setting bodies. However, if communications of the type discussed in this paragraph are intended to provide guidance on the application of accounting principles to a specific transaction, or on the type of opinion that may be rendered on a specific entity's financial statements, the provisions of this section should be followed.

## Performance Standards

.05 The reporting accountant should exercise due professional care in performing the engagement and should have adequate technical training and proficiency. The reporting accountant should also plan the engagement adequately, supervise the work of assistants, if any, and accumulate sufficient information to provide a reasonable basis for the professional judgment described in the report. The reporting accountant should consider who is the requester of the report, the circumstances under which the request is made, the purpose of the request, and the requester's intended use of the report.

.06 To aid in forming a judgment, the reporting accountant should perform the following procedures: (a) obtain an understanding of the form and substance of the transaction(s); (b) review applicable generally accepted accounting principles (see section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*); (c) if appropriate, consult with other professionals or experts; and (d) if appropriate, perform research or other procedures to ascertain and consider the existence of creditable precedents or analogies.

.07 When evaluating accounting principles or determining the type of opinion that may be rendered on an entity's financial statements at the request of a principal, or an intermediary acting for a principal, that relate to a specific transaction, or to a specific entity's financial statements, the reporting accountant should consult with the continuing accountant of the principal to ascertain all the available facts relevant to forming a professional judgment. The continuing accountant may provide information not otherwise available to the reporting accountant regarding, for example, the following: the form and substance of the transaction; how management has applied accounting principles to similar transactions; whether the method of accounting recommended by the continuing accountant is disputed by management; or whether the continuing accountant has reached a different conclusion on the application of accounting principles or the type of opinion that may be rendered on the entity's financial statements. The reporting accountant should explain to the principal or intermediary the need to consult with the continuing accountant, request permission to do so, and request the principal to authorize the continuing accountant to respond fully to the reporting accountant's inquiries. The responsibilities of a principal's continuing accountant to respond to inquiries by the reporting accountant are the same as the responsibilities of a predecessor auditor to respond to inquiries by a successor auditor. See section 315, *Communications Between Predecessor and Successor Auditors*, paragraph .07.

## Reporting Standards

**.08** The accountant's written report should be addressed to the principal to the transaction or to the intermediary, and should ordinarily include the following:<sup>4</sup>

- a. A brief description of the nature of the engagement and a statement that the engagement was performed in accordance with applicable AICPA standards.
- b. A description of the transaction(s), a statement of the relevant facts, circumstances, and assumptions, and a statement about the source of the information. Principals to specific transactions should be identified, and hypothetical transactions should be described as involving nonspecific principals (for example, Company A, Company B).
- c. A statement describing the appropriate accounting principle(s) to be applied or type of opinion that may be rendered on the entity's financial statements, and, if appropriate, a description of the reasons for the reporting accountant's conclusion.
- d. A statement that the responsibility for the proper accounting treatment rests with the preparers of the financial statements, who should consult with their continuing accountants.
- e. A statement that any difference in the facts, circumstances, or assumptions presented may change the report.

**.09** The following is an illustration of sections of the report described in paragraph .08.

### Introduction

We have been engaged to report on the appropriate application of generally accepted accounting principles to the specific (hypothetical) transaction described below. This report is being issued to the ABC Company (XYZ Intermediaries) for assistance in evaluating accounting principles for the described specific (hypothetical) transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

### Description of Transaction

The facts, circumstances, and assumptions relevant to the specific (hypothetical) transaction as provided to us by the management of the ABC Company (XYZ Intermediaries) are as follows:

### Appropriate Accounting Principles

*[Text discussing principles]*

### Concluding Comments

The ultimate responsibility for the decision on the appropriate application of generally accepted accounting principles for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountants. Our judgment on the appropriate application of generally accepted accounting principles for the described specific (hypothetical) transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

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[The next page is 1121.]

<sup>4</sup> Although the reporting standards in this section apply only to written reports, accountants may find this guidance useful in presenting oral advice.



## AU Section 634

### ***Letters for Underwriters***

Source: SAS No. 49.

See section 9634 for interpretations of this section.

Issue date, unless otherwise indicated: September, 1984.

.01 The services of independent certified public accountants include audit of financial statements and schedules contained in registration statements filed with the Securities and Exchange Commission (the SEC) under the Securities Act of 1933 (the Act). In connection with this type of service, accountants often are called upon to confer with clients, underwriters, and their respective counsel concerning the accounting and auditing requirements of the Act and of the SEC, as well as to perform other services. One of these other services is the issuance of letters for underwriters, commonly called *comfort letters*, which are generally concerned with the subjects described in paragraph .06.

.02 Much of the uncertainty and consequent risk of misunderstanding with regard to the nature and scope of comfort letters has arisen from a lack of recognition of the necessarily limited nature of the comments that accountants can properly make with respect to financial information, in a registration statement, that has not been audited in accordance with generally accepted auditing standards and accordingly is not covered by their opinion. Underwriters, in requesting comfort letters, are generally seeking assistance on matters of importance to them. They wish to perform a "reasonable investigation" of financial and accounting data not "expertized" (covered by a report of independent accountants, who consent to be named as experts, based on an audit performed in accordance with generally accepted auditing standards) as a defense against possible claims under the Act. Accountants have a corresponding wish, arising in response to the same statutory phrase, *reasonable investigation*, with respect to audited financial statements included in a

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*Note:* This section supersedes section 631, *Letters for Underwriters*. The changes to section 631 are in response to revisions of financial reporting requirements of the SEC and other developments in auditing and reporting practices. The principal changes are to add or revise guidance on the following:

- Shelf registration statements (paragraphs .08 and .48)
- Independence (paragraphs .13 and .36 and examples A and K)
- Compliance with SEC requirements (paragraph .15)
- Accountants' reports (paragraph .18 and footnotes 21 and 23)
- Pro forma financial information (paragraph .19g and example L)
- Comments on unaudited condensed interim financial statements that are not included in the registration statement (paragraph .24)
- Comments on subsequent changes and decreases (paragraph .31)
- Tables, statistics, and other financial information (paragraph .43 and example J)

This section also includes certain minor revisions, such as to references to SEC regulations; the paragraphs have also been renumbered.

prospectus in reliance on their audit report and their consent.<sup>1</sup> The accountants' reasonable investigation must be premised upon an audit; it cannot be accomplished short of an audit. What constitutes a reasonable investigation of unaudited financial information sufficient to satisfy an underwriter's purposes has never been authoritatively established. Consequently, only the underwriter can determine what is sufficient for his purposes. Accountants will normally be willing to assist the underwriter, but the assistance accountants can provide by way of comfort letters is subject to limitations. One limitation is that an independent accountant can properly comment in his professional capacity only on matters to which his professional expertise is substantially relevant. Another limitation is that procedures short of an audit, such as those contemplated in a comfort letter, provide the accountant with a basis for expressing, at the most, negative assurance.<sup>2</sup> Such limited procedures may bring to the accountant's attention significant matters affecting the financial information, but they do not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit. Accordingly, there is necessarily a risk that the conditions or matters about which the accountant has provided negative assurance of their absence may prove to have existed.

.03 This section deals with several different kinds of matters. First, in a number of areas involving professional standards, it states whether or not it is proper for independent certified public accountants acting in their professional capacity to comment on specified kinds of matters, and, if so, what the form of comment should be. Second, suggestions of a practical nature are offered on such matters as forms of comfort letters suitable to various circumstances, the way in which a particular form of letter may be agreed upon, the dating of letters, and what steps may be taken when information that may require special mention in a letter comes to the accountants' attention.<sup>3</sup> Third, ways are suggested to reduce or avoid the uncertainties described in the preceding paragraph regarding the nature and extent of accountants' responsibilities in connection with a comfort letter. In regard to this and other points not involving professional standards, where the recommendations are intended to reduce risks of misunderstanding, accountants requested to follow a course other than that recommended would do well to consult their counsel.

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<sup>1</sup> See section 711, *Filings Under Federal Securities Statutes*, for a discussion of certain responsibilities of accountants resulting from inclusion of their reports in registration statements.

<sup>2</sup> Negative assurance consists of a statement by accountants that, as a result of specified procedures, nothing came to their attention that caused them to believe that specified matters do not meet a specified standard (for example, that unaudited financial statements or unaudited condensed financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements).

<sup>3</sup> It is important to note that although the illustrations in this section describe procedures that are frequently followed by accountants as a basis for their comments in comfort letters, it does not prescribe such procedures.

.04 Comfort letters are not required under the Act, and copies are not filed with the SEC. It is nonetheless a common condition of an underwriting agreement in connection with the offering for sale of securities registered with the SEC under the Act that the accountants are to furnish a comfort letter. Some underwriters do not make the receipt of a comfort letter a condition of the underwriting agreement but nevertheless ask for such a letter.<sup>4</sup>

.05 The accountants should suggest to the underwriter that they meet together with the client to discuss the procedures to be followed in connection with a comfort letter; in this connection, the accountants may describe procedures frequently followed (see examples included at the end of this section, paragraphs .48 through .60). Because of the accountants' knowledge of the client, such a meeting may substantially assist the underwriter in reaching his decision about the procedures to be followed by the accountants. However, it is still advisable to accompany any discussion of procedures with a clear statement that the accountants cannot furnish any assurance regarding the sufficiency of the procedures for the underwriter's purposes, and it is advisable for the comfort letter to contain a statement to this effect. An appropriate way of expressing this is shown in numbered paragraph 4 of example A.

.06 Comfort letters will generally refer to one or more of the following subjects:

- a. The independence of the accountants
- b. Compliance in form in all material respects of the audited financial statements and schedules included in the registration statement with the applicable accounting requirements of the Act and the related published rules and regulations
- c. Unaudited financial statements, condensed interim financial statements, capsule information, or pro forma financial information included in the registration statement
- d. Changes in selected financial statement items during a period subsequent to the date and period of the latest financial statements included in the registration statement
- e. Tables, statistics, and other financial information included in the registration statement<sup>5</sup>

These matters are discussed in greater detail below and are illustrated in the examples included at the end of this section. Matters dealt with in a

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<sup>4</sup> Except where the context otherwise requires, the word *underwriter*, as used in this section, refers to the managing, or lead, underwriter, who typically negotiates the underwriting agreement for a group of underwriters whose exact composition is not determined until shortly before a registration statement becomes effective. In competitive bidding situations where legal counsel for the underwriters acts as the underwriters' representative prior to the opening and acceptance of the bid, the accountants should carry out the discussions and other communications contemplated by this section with the legal counsel until the underwriter is selected.

<sup>5</sup> Financial information included in a registration statement also includes information incorporated in the registration statement by reference.

particular letter usually are limited to ones specified in the underwriting agreement.

.07 Because the underwriter will expect the accountants to furnish a comfort letter of a scope to be specified in the underwriting agreement, the client and the underwriter, when they have tentatively agreed upon a draft of the agreement, are well advised to furnish a copy of it to the accountants so that the latter can indicate whether they will be able to furnish a letter in acceptable form. A desirable practice is for the accountants, promptly after they have received the draft of the agreement (or have been informed that a letter covering specified matters, although not a condition of the agreement, will nonetheless be requested), to prepare a draft of the form of letter that they expect to furnish. To the extent possible, the draft should deal with all matters to be covered in the exact terms to be used in the final letter (subject, of course, to the understanding that the comments in the final letter cannot be determined until the procedures underlying it have been performed). The draft letter should be identified as a draft in order to avoid giving the impression that the procedures described therein have been performed. This practice of furnishing a draft letter at an early point permits the accountants to make clear to the client and the underwriter what they may expect the accountants to furnish and gives the client and the underwriter an opportunity to change the proposed underwriting agreement if they so desire. The underwriter thus furnished with a draft letter is afforded the opportunity to discuss further with the accountants the procedures that the accountants have indicated they expect to follow and to request any additional procedures that the underwriter may desire. If the additional procedures pertain to matters to which the accountants' professional competence is relevant, the accountants would ordinarily be willing to perform them, and it is desirable for them to furnish the underwriter with an appropriately revised draft letter. The accountants may reasonably assume that the underwriter, by indicating his acceptance of the draft comfort letter, and subsequently, by his acceptance of the letter in final form, considers the procedures described sufficient for his purposes. It is important, therefore, that the procedures to be followed by the accountants be clearly set out in the comfort letter, in both draft and final form, so that there will be no misunderstanding about the basis upon which the accountants' comments have been made and so that the underwriter can decide whether the procedures performed are sufficient for his purposes. For reasons explained in paragraph .02, statements or implications that the accountants are carrying out such procedures as they consider necessary should be avoided since this may lead to misunderstanding about the responsibility for the sufficiency of the procedures for the underwriter's purposes. The following is a suggested form of legend that may be placed on the draft letter for identification and explanation of its purposes and limitations.

This draft is furnished solely for the purpose of indicating the form of letter that we would expect to be able to furnish [name of underwriter] in

response to their request, the matters expected to be covered in the letter, and the nature of the procedures that we would expect to carry out with respect to such matters. Based on our discussions with [name of underwriter], it is our understanding that the procedures outlined in this draft letter are those they wish us to follow.<sup>6</sup> Unless [name of underwriter] informs us otherwise, we shall assume that there are no additional procedures they wish us to follow. The text of the letter itself will depend, of course, upon the results of the procedures, which we would not expect to complete until shortly before the letter is given and in no event before the cutoff date indicated therein.

.08 Regulations under the Act permit, in certain circumstances, companies to register a designated amount of securities for continuous or delayed offerings during an extended period by filing one “shelf” registration statement. At the effective date of a shelf registration statement, the registrant may not have selected an underwriter (see footnote 4). A client or the legal counsel designated to represent the underwriting group might, however, ask the accountants to issue a comfort letter at the effective date of a shelf registration statement to expedite the due diligence activities of the underwriter when he is subsequently designated and to avoid later corrections of financial information included in an effective prospectus. However, as stated in paragraph .02, only the underwriter can determine the procedures that will be sufficient for his purposes. In these circumstances, therefore, the accountants should not agree to furnish a comfort letter addressed to the client or legal counsel or to a nonspecific addressee such as to “any or all underwriters to be selected.”<sup>7</sup> The accountants may agree to furnish the client or the legal counsel for the underwriting group with a draft comfort letter describing the procedures that the accountants have performed and the comments the accountants are willing to express as a result of those procedures. The draft comfort letter should include a legend describing its purpose and limitations such as the following.

This draft describes the procedures that we have performed and represents a letter we would be prepared to sign as of the effective date of the registration statement if the managing underwriter had been chosen at that date and requested such a letter. Based on our discussions with [name of client or legal counsel], the procedures set forth are similar to those that experience indicates underwriters often request in such circumstances. The text of the final letter will depend, of course, on whether the managing underwriter who

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<sup>6</sup> In the absence of any discussions with the underwriter, the accountants should outline in the draft letter those procedures specified in the underwriting agreement that they are willing to perform. In that event, this sentence should be revised as follows: “In the absence of any discussions with [name of underwriter], we have set out in this draft letter those procedures referred to in the draft underwriting agreement (of which we have been furnished a copy) that we are willing to follow.”

<sup>7</sup> This section is not intended to preclude accountants from providing to the client's board of directors, when appropriate, a letter addressed to the board of directors similar in content to a comfort letter. For example, see the auditing interpretation, “Letters to Directors Relating to Annual Reports on Form 10-K” (April 1981). (Section 9634.01—.09.)

is selected requests that other procedures be performed to meet his needs and whether the managing underwriter requests that any of the procedures be updated to the date of issuance of the signed letter.

A signed comfort letter may be issued to the underwriter selected for the portion of the issue then being offered when the underwriting agreement for an offering is signed and at each closing date.

## Dating

.09 The letter ordinarily is dated at or shortly before the *closing date* (the date on which the issuer or selling security holder delivers the securities to the underwriter in exchange for the proceeds of the offering). The underwriting agreement ordinarily specifies the date, often referred to as the *cutoff date*, to which the letter is to relate (for example, a date five business days before the date of the letter); the accountants should see that the cutoff date will not place an unreasonable burden on them. The letter should state that the inquiries and other procedures carried out in connection with the letter did not cover the period from the cutoff date to the date of the letter.

.10 Letters may also be dated at or shortly before the *effective date* (the date on which the registration statement becomes effective); and, on rare occasions, letters have been requested to be dated at or shortly before the *filing date* (the date on which the registration statement is first filed with the SEC). If more than one letter is requested, it will be necessary to carry out the specified procedures and inquiries as of the cutoff date for each letter. Although comments contained in an earlier letter may on occasion conveniently be incorporated by reference in a subsequent letter (see example C), any subsequent letter should relate only to information in the registration statement as most recently amended.

## Addressee

.11 Because the letter is a result of the underwriter's request, many accountants address the letter only to the underwriter, with a copy furnished to the client. When this is done, the appropriate addressee is the underwriter who has negotiated the underwriting agreement with the client, and with whom the accountants will deal in discussions regarding the scope and sufficiency of the letter, rather than the group of underwriters for whom that underwriter acts as representative.<sup>8</sup> Some accountants address the letter instead to the client, or to both the client and the underwriter. If the accountants are requested to address the letter to any person other than the underwriter or the client, they should consider consulting their legal counsel.

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<sup>8</sup> An appropriate form of address for this purpose is "XYZ & Company, as Representative of the Several Underwriters."

## Introductory Paragraph

.12 It is desirable to include an introductory paragraph substantially as follows:

We have audited the [identify the financial statements and schedules audited] included [incorporated by reference] in the registration statement (no. 2-00000) on Form \_\_\_\_\_ filed by the company under the Securities Act of 1933 (the Act); our reports with respect thereto are also included [incorporated by reference] in that registration statement. The registration statement, as amended as of \_\_\_\_\_, is herein referred to as the registration statement.

## Independence

.13 It is customary for the underwriting agreement to provide for the accountants to make a statement concerning their independence in the letter. This may be done substantially as follows:

We are independent certified public accountants with respect to The Blank Company, Inc., within the meaning of the Act and the applicable published rules and regulations thereunder.

Regulation S-K requires disclosure in the prospectus and registration statement of interests of named experts (including independent accountants) in the registrant. Regulation S-X precludes an accountant who reports on financial statements in a registration statement from having interests of the type requiring disclosure in the prospectus or registration statement. Therefore, if an accountant makes a statement in a comfort letter that he is independent within the meaning of the Act and the applicable published rules and regulations thereunder, any additional comments on independence would be unnecessary. (See paragraph .36 regarding instances when the accountants' client is not the registrant.)

## Compliance With SEC Requirements

.14 The accountants may be requested to express an opinion concerning compliance as to form of the financial statements covered by their report with the pertinent published accounting requirements of the SEC.<sup>9</sup> This may be done substantially as follows:

In our opinion [include phrase, "except as disclosed in the registration statement," if applicable], the [identify the financial statements and schedules audited] audited by us and included or incorporated by reference in the registration statement comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations.<sup>10</sup>

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<sup>9</sup> The word *published* is used because accountants should not be expected to be familiar with, or express assurances as to compliance with, informal requirements that have not been published by the SEC but that may be applied by the SEC staff.

<sup>10</sup> Certain financial statements may be incorporated in a registration statement under the Securities Act of 1933 by reference to filings under the Securities Exchange Act of 1934 (the 1934 Act). In those circumstances, the accountants may refer to compliance in form in all material respects of the audited financial statements and schedules included or incorporated by reference in the registration statement with the applicable accounting requirements of the 1934 Act and the related published rules and regulations (see example K). However, the accountants should not refer to compliance with the provisions of the 1934 Act regarding internal accounting control. See the auditing interpretation, "Compliance with the Foreign Corrupt Practices Act of 1977" (October 1978). (Section 9642.10—.13.)

If there is a material departure from the pertinent published requirements, the departure should be disclosed in the letter. Normally, representatives of the SEC will have agreed to such a departure; when this occurs, the agreement should be mentioned in the comfort letter.<sup>11</sup> An appropriate manner of doing this is shown in example D.

.15 Accountants may comment on compliance as to form with requirements under published SEC rules and regulations only with respect to those rules and regulations applicable to the form and content of financial statements and schedules. Accountants should not comment on compliance as to form of other information included in the registration statement, for example, the ratio of earnings to fixed charges, selected financial data, executive compensation, and industry statistical data. (See paragraph .20 regarding unaudited condensed interim financial statements and paragraph .19g regarding pro forma financial information.)

## Accountants' Reports

.16 Underwriters occasionally request the accountants to repeat in the comfort letter their opinion on the audited financial statements included in the registration statement. Because of the special significance of the date of an accountant's report, the accountants should not repeat their opinion.<sup>12</sup> Underwriters sometimes request negative assurance regarding the accountants' opinion. Because accountants have a statutory responsibility with respect to their opinion as of the effective date, and because the additional significance, if any, of negative assurance is unclear and such assurance may therefore give rise to misunderstanding, accountants should not give such negative assurance. Also, the accountants should not give negative assurance with respect to financial statements and schedules that have been audited and are reported on in the registration statement by other accountants.

.17 An underwriter may also request the accountants to comment in their comfort letter on (a) unaudited interim financial information required by item 302(a) of SEC Regulation S-K, to which section 722 relates, or (b) required supplementary information, to which section 558 relates. Sections 558 and 722 provide that the accountant should expand his standard report on the audited financial statements to refer to such information when the scope of his procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or (for required supplementary information) applicable guidelines. Such expansions of the accountants' standard report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (see paragraphs .32 through .35). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests the accountants to perform procedures with regard to such information in addition to the procedures performed in connection with the audit as prescribed by sections 558 and 722, the accountants may do so and report their findings.

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<sup>11</sup> Departures from published SEC requirements that require mention in a comfort letter ordinarily do not affect fair presentation in conformity with generally accepted accounting principles; however, if they do, the accountants will of course take cognizance of these departures in expressing their opinion and in consenting to the use of their report in the registration statement. If departures from published SEC requirements that require mention in a comfort letter either are not disclosed in the registration statement or have not been agreed to by representatives of the SEC, the accountants should consider carefully the issuance of a consent to the use of their report in the registration statement.

<sup>12</sup> See section 530.03—.08.



.18 The accountants may refer in the introductory paragraphs of the comfort letter to the fact that they have issued reports on—

- a. Condensed financial statements that are derived from audited financial statements (see section 552).
- b. Selected financial data (see section 552).
- c. A review of interim financial information (see section 722).
- d. Pro forma financial information (see AT section 300, *Reporting on Pro Forma Financial Information*) (or a financial forecast filed in lieu of a pro forma condensed income statement [See AT section 200, *Financial Forecasts and Projections*]).

Such a reference should be to the accountants' reports that were previously issued, and if not included in the registration statement, the reports may be attached to the comfort letter. In referring to previously issued reports, the accountants should not repeat their reports in the comfort letter or otherwise imply that they are reporting as of the date of the comfort letter or that they assume responsibility for the sufficiency of the procedures for the underwriter's purposes. However, for certain information on which they have reported, the accountants may agree to comment regarding compliance with published SEC requirements (see paragraph .15).

## **Unaudited Condensed Interim Financial Statements, Capsule Information, and Subsequent Changes**

### **In General**

.19 Comments included in the letter will often concern<sup>13</sup> (1) unaudited condensed interim financial statements included in the registration statement (see paragraphs .20 and .21),<sup>13</sup> (2) capsule information (see paragraphs .22 through .24), (3) changes in capital stock and long-term debt and decreases in other specified financial statement items (see paragraphs .25 through .30), and (4) pro forma financial information. In commenting on these matters, the following guides are important:

- a. Any statements by the accountants with respect to unaudited condensed interim financial statements, capsule information, and subsequent changes or decreases should be limited to negative assurance. An appropriate manner of expressing the comments is shown in numbered paragraph 5 of example A.
- b. As explained in paragraph .07, the agreed-upon procedures performed by the accountants should be set forth in the letter. Such procedures are generally described along the lines of numbered paragraph 4 of example A.
- c. To avoid any misunderstanding about the responsibility for the sufficiency of the agreed-upon procedures for the underwriter's purposes, the accountants should not make any statements or imply that they have applied procedures that they have determined to be necessary or sufficient for the underwriter's purposes. In this respect, the underwriter may request the accountants to perform procedures similar to those in section 722.13. However, for the

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<sup>13</sup> The SEC requirements specify condensed financial statements. However, the guidance in paragraphs .19 through .21 also applies to complete financial statements. For purposes of this section, interim financial statements may be for a twelve-month period ending on a date other than the entity's normal year-end.

accountants to include such procedures in their letter, the underwriter would have to provide sufficiently specific criteria so that there is no implication that the responsibility for the sufficiency of the agreed-upon procedures has been assumed by the accountants. For example, if the underwriter requests the accountants to apply analytical procedures and specifies items of financial information to be reviewed and the materiality level for changes in those items that would necessitate further inquiry by the accountants, the accountants may refer to those procedures in their letter. Descriptions of procedures in the comfort letter should include descriptions of the criteria specified by the underwriter. [Reference changed by the issuance of SAS No. 71.]

- d. Terms of uncertain meaning, such as *general review*, *limited review*, *check*, or *test*, should not be used in describing the work, unless the procedures comprehended by the terms are described in the comfort letter.
- e. The letter should specifically identify any unaudited condensed interim financial statements and should state that the accountants have not audited the condensed interim financial statements in accordance with generally accepted auditing standards and do not express an opinion concerning them. An appropriate manner of making this clear is shown in numbered paragraph 3 of example A (see also paragraph .21).
- f. The accountants should not give negative assurance with respect to unaudited condensed interim financial statements, capsule information, or changes or decreases unless they have obtained knowledge of the client's accounting and financial reporting practices and its internal control structure relating to the preparation of financial statements. An understanding of the client's practices in preparing its most recent annual financial statements provides a practical basis for the accountants' inquiries or procedures. Ordinarily, accountants obtain such an understanding in auditing the client's financial statements for one or more annual periods. However, if for whatever reason the accountants have not conducted such an audit, the need for an understanding of the client's accounting and financial reporting practices and its internal control structure is not diminished, and the accountants should consider whether, under the particular circumstances, they can acquire sufficient knowledge of these matters to perform the inquiries and procedures requested by the underwriter.
- g. The accountants should not give negative assurance on the application of pro forma adjustments to historical financial statements, the compilation of pro forma financial information, or whether the pro forma financial information complies as to form with published SEC rules and regulations unless (1) they have performed an audit of the historical financial statements of the entity (or, in the case of business combinations, of a significant constituent part of the combined entity) (a) for the period presented or (b) in the case of interim periods for the latest fiscal period that includes or precedes the interim period, or (2) they have otherwise obtained knowledge of

the entity's accounting and financial reporting practices and its internal control structure as provided for in *f* above.<sup>14</sup> (See example L.)

- h.* The procedures followed with respect to interim periods may not disclose changes in capital stock or long-term debt or decreases in the specified financial statement items, inconsistencies in the application of generally accepted accounting principles, instances of noncompliance in form with accounting requirements of the SEC, or other matters about which negative assurance is requested. An appropriate manner of making this clear is shown in the last three sentences in paragraph 4 of example A.
- i.* The working papers relating to comfort letters should be prepared in such a manner that they constitute an adequate record of what has been done.

### Unaudited Condensed Interim Financial Statements

.20 Comments in the comfort letter concerning the unaudited condensed interim financial statements appearing in the registration statement should always be made in the form of negative assurance.<sup>15</sup> Frequently, such comments relate to (a) conformity with generally accepted accounting principles, (b) substantial consistency with the audited financial statements included in the registration statement, and (c) compliance in form with applicable SEC accounting requirements. An appropriate manner of expressing the comments is shown in numbered paragraph 5a of example A.

.21 When the most recent figures included in a condensed statement of income are for a period of less than one year, the SEC requires that comparative figures be shown for the corresponding short period of the preceding year. The condensed financial statements for the latest interim period and the preceding year are ordinarily unaudited. In these circumstances, the unaudited status of the condensed financial statements should be made clear in the comfort letter (see numbered paragraph 3 of example A and paragraph .19e).

### Capsule Information

.22 In some registration statements the information shown in the audited financial statements or unaudited condensed interim financial statements is supplemented by unaudited summarized interim information for subsequent periods (commonly called *capsule information*). This capsule information (either in narrative or tabular form) is often provided for the most recent interim period and for the corresponding period of the prior year. With regard to selected capsule information, the accountants—

- a.* May give negative assurance in regard to conformity with generally accepted accounting principles and may refer to whether the dollar amounts were determined on a basis substantially consistent with that of the corresponding amounts in the audited financial state-

[The next page is 1131-3.]

<sup>14</sup> Regulation S-X permits a financial forecast to be filed in lieu of the required pro forma condensed income statement. Because of the unique responsibilities of the accountants regarding financial forecasts, the accountants should not include in a comfort letter any description of procedures or any assurance based on those procedures regarding a financial forecast. (See paragraph .18 regarding reference in a comfort letter to an accountant's report on a financial forecast.) This prohibition also applies to other prospective financial information included in the registration statement.

<sup>15</sup> See section 504, *Association With Financial Statements*, paragraphs .18 through .20.

ments if the selected capsule information is presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30 [AC section I73.146], or

- b. May refer only to whether the dollar amounts were determined on a basis substantially consistent with that of the corresponding amounts in the audited financial statements if the selected capsule information is more limited than the minimum disclosures described in APB Opinion No. 28, paragraph 30 [AC section I73.146] (see example E).

.23 The underwriter occasionally asks the accountants to give negative assurance with respect to the unaudited interim financial statements or unaudited condensed interim financial statements (see the interim financial information requirements of Regulation S-X) that underlie the capsule information and asks the accountants to state that the capsule information agrees with amounts set forth in such statements. Paragraphs 4b and 5b in example E provide an example of the accountants' comments in these circumstances.

.24 The underwriter might ask the accountants to give negative assurance with respect to unaudited condensed interim financial statements for a period ending after the latest financial statements included in the registration statement. In those cases, the unaudited condensed interim financial statements (see the interim financial information requirements of Regulation S-X) should be attached to the comfort letter. If the client requests, the unaudited condensed interim financial statements may be attached only to the copy of the letter intended for the managing underwriter.

### Subsequent Changes

.25 Comments regarding subsequent changes also should be in the form of negative assurance. They should not relate to "adverse changes" since, despite long use, that term has not acquired any defined or clearly understood meaning in an accounting sense. In fact, underwriters occasionally may have misinterpreted that term as encompassing judgments and conclusions not contemplated by the accountants. For example, there has been no agreement among accountants, clients, and underwriters regarding whether the term relates only to absolute changes or also includes trends in amounts or ratios. Further, there are differences of view regarding whether an adverse change in results of operations is indicated solely by a decrease in net income or whether it also encompasses changes in sales, cost of sales, and other factors that separately or together might indicate the beginning or accentuation of an adverse trend. Also, the term has sometimes been construed as contemplating comments by accountants regarding matters to which their professional competence has little relevance, such as evaluating whether certain types of expenses that may decrease current income but are designed to increase future income (for example, research and development costs, major advertising campaigns, and systems installations) are adverse or not. In order that comments on subsequent changes be unambiguous and their determination be within the professional competence of accountants, the comments should not relate to adverse changes but should ordinarily relate to whether there has been any change in capital stock or long-term debt or "decreases" in other specified financial statement items during a period known as the *change period* (see paragraph .27). Usually these items would include the amounts of net current assets, net assets (stockholders' equity), and net sales and the total and/or per-share amounts of income before extraordinary items and of net income. An appropriate manner of expressing the comments is shown (a) in numbered

paragraph 5*b* of example A if there has been no decrease and (*b*) in example F if there has been a decrease.

**.26** Matters to be covered by the letter should be made clear in the meetings with the underwriter and should be contemplated by the underwriting agreement and in the draft comfort letter. Since there is no way of anticipating other matters that would be of interest to an underwriter, accountants should not make a general statement in comfort letters that, as a result of carrying out the specified procedures, nothing else has come to their attention that would be of interest to the underwriter.

**.27** In the context of a comfort letter, a decrease occurs when the amount of a financial statement item at the cutoff date or for the change period (as if financial statements and their notes had been prepared at that date and for that period) is less than the amount of the same item at a specified earlier date or for a specified earlier period. With respect to the items mentioned in paragraph .25, the term *decrease* means (a) any combination of changes in amounts of current assets and current liabilities that results in decreased net current assets, (b) any combination of changes in amounts of assets and liabilities that results in decreased net assets, (c) decreased net sales, and (d) any combination of changes in amounts of sales and expenses and/or outstanding shares that results in decreased total and/or per-share amounts of income before extraordinary items and of net income (including, in each instance, a greater loss or other negative amount). The change period for which the accountants give negative assurance in the comfort letter ends on the cutoff date (see paragraph .09) and ordinarily begins (a) for balance sheet items, immediately after the date of the latest balance sheet in the registration statement, and (b) for income statement items, immediately after the latest period for which such items are presented in the registration statement. The comparison relates to the entire period and not to portions thereof. A decrease during one part of a period may be offset by an equal or larger increase in another part of the period; however, because there was no decrease for the period as a whole, the comfort letter would not report the decrease occurring during one part of the period (see, however, paragraph .47).

**.28** Underwriters occasionally request that the change period begin immediately after the date of the latest audited balance sheet (ordinarily also the closing date of the latest audited statement of income) in the registration statement, even though the registration statement includes a more recent unaudited condensed balance sheet and condensed statement of income. The use of the earlier date may defeat the underwriter's purpose since it is possible that an increase in one of the items referred to in paragraph .25 occurring between the dates of the latest audited and unaudited balance sheets included in the registration statement might more than offset a decrease occurring after the latter date. A similar situation might arise in the comparison of income statement items. In these circumstances, the decrease occurring after the date of the latest unaudited condensed interim financial statements included in the registration statement would not be reported in the comfort letter. It is desirable for the accountants to explain the foregoing considerations to the underwriter; however, if the underwriter nonetheless requests the use of a change period or periods other than those described in paragraph .27, the accountants may use the period or periods requested.

**.29** The underwriting agreement usually specifies the dates and periods with which data at the cutoff date and for the change period are to be compared. For balance sheet items the comparison date is normally that of the latest balance sheet included in the registration statement (that is, immediately prior to the beginning of the change period). For income statement items the comparison period or periods might be one or more of the following: (a) the corresponding period of the preceding year, (b) a period of corresponding

length immediately preceding the change period, (c) a proportionate part of the preceding fiscal year, or (d) any other period of corresponding length chosen by the underwriter. Whether or not specified in the underwriting agreement, the date and period used in comparison should be identified in the comfort letter in both draft and final form so that there is no misunderstanding about the matters being compared and so that the underwriter can determine whether the comparison period is suitable for his purposes.

.30 In addition to making the comparisons indicated above using the financial statements made available to them, the accountants will ordinarily be requested to read minutes and make inquiries of company officials relating to the whole of the change period.<sup>16</sup> For the period between the date of the latest financial statements made available and the cutoff date, the accountants must necessarily base their comments solely on the limited procedures actually performed with respect to that period (which in most cases will be limited to the reading of minutes and the inquiries of company officials referred to in the preceding sentence), and their comfort letter should make this clear (see numbered paragraph 6 of example A).

### Disclosure in Registration Statement

.31 Comments on the occurrence of changes in capital stock or long-term debt and decreases in other specified financial statement items are limited to changes or decreases not disclosed in the registration statement. Accordingly, the phrase “except for changes or decreases that the registration statement discloses have occurred or may occur” should be included in the letter when it has come to the accountants’ attention that a change or decrease has occurred during the change period, and the change or decrease is disclosed in the registration statement. The above phrase need not be included in the letter when no changes or decreases in the specified financial statement items are disclosed in the registration statement.

### Effect of Qualified Opinion

.32 The foregoing discussion contemplates that the accountants’ opinion on the financial statements and schedules in the registration statement is unqualified.<sup>17</sup> This usually is the case. Except in extraordinary circumstances, the requirements of the SEC do not permit a registration statement to become effective when the accountants’ opinion is qualified in regard to the scope of their audit or the accounting principles reflected in the financial statements and schedules. However, such circumstances do occasionally arise, and although the SEC may permit the registration statement to become effective even though the opinion is qualified, the accountants may not be in a position to give an unqualified opinion that the financial statements in the registration statement comply in form in all material respects with the published rules and regulations of the SEC under the Act (see paragraph .14).

.33 [Paragraph deleted to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

.34 If the opinion is qualified, the qualification should be referred to in the opening paragraph of the comfort letter by saying, for example, “our

<sup>16</sup> The answers to these inquiries generally should be supported by appropriate written representations of the company officials.

<sup>17</sup> Certain circumstances, while not affecting the auditor’s unqualified opinion, may require that the auditor add an explanatory paragraph (or other explanatory language) to the standard report. See section 508, *Reports on Audited Financial Statements*, paragraph .11. [Footnote added to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

reports (which contain a qualification as set forth therein) with respect thereto are also included in the registration statement.”<sup>18</sup>

.35 If the letter includes negative assurance with respect to subsequent unaudited condensed interim financial statements included in the registration statement or with respect to an absence of specified subsequent changes or decreases, the effect thereon of the subject matter of the qualification should also be considered. An illustration of how this type of situation may be dealt with is shown in example G.

## Other Accountants

.36 Comfort letters are occasionally requested from more than one accountant (for example, in connection with registration statements to be used in the subsequent sale of shares issued in recently effected mergers). In these circumstances, each accountant must, of course, be sure he is independent within the meaning of the Act and the applicable published rules and regulations thereunder. In connection with opinions expressed prior to the acquisitions, the accountants for previously nonaffiliated companies recently acquired by the registrant would not be required to have been independent with respect to the company whose shares are being registered. In such a case, the accountants should modify the wording suggested in paragraph .13 and make a statement regarding their independence along the following lines.

As of [insert date of the accountants' most recent report on the financial statements of their client] and during the period covered by the financial statements on which we reported, we were independent certified public accountants with respect to [insert the name of their client] within the meaning of the Act and the applicable published rules and regulations thereunder.

.37 There may be situations in which more than one accountant is involved in the audit of the financial statements of a business and in which the reports of more than one accountant appear in the registration statement. For example, certain significant divisions, branches, or subsidiaries may be audited by other accountants. The principal accountants (those who report on the consolidated financial statements and consequently are asked to give a comfort letter with regard to information expressed on a consolidated basis) should read the letters of the other accountants reporting on significant units. Such letters should contain statements similar to those contained in the comfort letter prepared by the principal accountants, including statements about their independence. The principal accountants should state in their comfort letter that (a) reading letters of other accountants was one of the procedures followed, and (b) the procedures performed by the principal accountants (other than reading the letters of the other accountants) relate solely to (1) companies audited by the principal accountants and (2) the consolidated financial statements. An appropriate manner of expressing these comments where the letters of the other accountants do not disclose matters that affect the negative assurance given is shown in example H. If the letters of the other accountants disclose decreases in financial statement items or any other matters that affect the negative assurance that is given, the principal accountants should mention these matters in their letter. Where appropriate,

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<sup>18</sup> The accountants may also refer in the opening paragraph to expansions of their report that do not affect their opinion, for example, expansions of their report regarding interim financial information accompanying or included in the notes to audited financial statements (see section 722, *Interim Financial Information*, paragraphs .41 and .42) or required supplementary information described in section 558, *Required Supplementary Information*, paragraphs .08 through .10. See paragraph .17 herein. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62. Reference changed by the issuance of SAS No. 71.]



the principal accountants may comment that there were no decreases in the consolidated financial statement items despite the decreases mentioned by the other auditors. In such a case, the principal accountants could give negative assurance that nothing had come to their attention regarding the consolidated financial statements as a result of the specified procedures (which, so far as the related company was concerned, consisted solely of reading the other accountants' letter) that caused them to believe that. . . .

.38 At the earliest practicable date, the client should advise any other accountants who may be involved about any letter that may be required from them and should arrange for them to receive a draft of the underwriting agreement so that they may make arrangements at an early date for the preparation of a draft of their letter (a copy of which should be furnished to the principal accountants) and for the performance of their procedures. In addition, the underwriter may desire to meet with the other accountants for the purposes discussed in paragraph .05.

.39 When a comfort letter is furnished to other accountants, it should be addressed in accordance with paragraph .11, and copies should be furnished to the principal accountants and their client. The letter should contain a concluding paragraph similar to the example in paragraph .46.

## Tables, Statistics, and Other Financial Information

.40 The underwriting agreement sometimes calls for a comfort letter that includes comments on tables, statistics, and other financial information appearing in the registration statement.

.41 The accountants should refrain from commenting on matters to which their competence as independent public accountants has little relevance. Accordingly, except as indicated in the next sentence, they should comment only with respect to information (a) that is expressed in dollars (or percentages derived from such dollar amounts) and has been obtained from accounting records that are subject to the internal controls of the company's accounting system or (b) that has been derived directly from such accounting records by analysis or computation. The accountants may also comment on quantitative information that has been obtained from an accounting record if the information is of a type that is subject to the same controls as the dollar amounts. Accountants should not comment on matters involving primarily the exercise of business judgment of management. For example, changes between periods in gross profit ratios or net income may be caused by factors that are not necessarily within the expertise of accountants. The accountants should not comment on matters merely because they happen to be present and are capable of reading, counting, measuring, or performing other functions that might be applicable. Examples of matters that, unless subjected to the internal controls of the formal accounting system (which is not ordinarily the case), should not be commented on by the accountants include square footage of facilities, number of employees (except as related to a given payroll period), and backlog information. The accountants should not comment on tables, statistics, and other financial information relating to an unaudited period (a) unless they have performed an audit of the client's financial statements for a period including or immediately prior to the unaudited period or have completed an audit for a later period, or (b) unless they have otherwise obtained knowledge of the client's accounting and financial reporting practices and its internal control structure as provided for in paragraph .19f herein.

.42 As with comments relating to financial statement information, it is important that the procedures followed by the accountants with respect to other information be clearly set out in the comfort letter, in both draft and

final form, so that there will be no misunderstanding about the basis of comments on the information. Further, so that there will be no implication that the accountants are furnishing any assurance with respect to the sufficiency of the procedures for the underwriter's intended purpose, it is advisable for the comfort letter to contain a statement to this effect. An appropriate way of expressing this is shown in numbered paragraph 10 of example I (see also paragraph .07 of this section).

**.43** In order to avoid ambiguity, the specific information commented on in the letter should be identified by reference to specific captions, tables, page numbers, or specific paragraphs or sentences. Descriptions of the procedures followed and the findings may be stated individually for each item of specific information commented on. Alternatively, some or all of the descriptions may be grouped or summarized if the procedures and findings are adequately described, if the descriptions do not imply that the accountants assume responsibility for the adequacy of the procedures, and if it is unlikely that the applicability of the descriptions to items in the registration statement will be misunderstood.

**.44** Comments in the comfort letter concerning tables, statistics, and other financial information included in the registration statement should be made in the form of a description of the procedures followed, the findings (ordinarily expressed in terms of agreement between items compared), and in some cases, as described below, statements with respect to the acceptability of methods of allocation used in deriving the figures commented upon. Whether comments upon the allocation of income or expense items between such categories as military and commercial sales may appropriately be made will depend upon the extent to which such allocation is made in, or can be derived directly by analysis or computation from, the client's accounting records. In any event, such comments, if made, should make clear that such allocations are to a substantial extent arbitrary, that the method of allocation used is not the only acceptable one, and that other acceptable methods of allocation might produce significantly different results. Furthermore, no comments should be made regarding segment information (or the appropriateness of allocations made to derive segment information) included in financial statements, since the auditor's report encompasses that information (see section 435).<sup>19</sup> Appropriate ways of expressing comments on tables, statistics, and other financial information are shown in example I and example J.

**.45** In comments concerning tables, statistics, and other financial information, the expression *presents fairly* (or a variation of it) should not be used. That expression, when used by independent certified public accountants, ordinarily relates to presentations of financial statements and should not be used in commenting on other types of information. Except with respect to requirements for financial statements, the question of what constitutes appropriate information for compliance with the requirements of a particular item of the registration statement form (for example, whether particular employee benefits constitute executive compensation as defined by SEC regulations) is a matter of legal interpretation outside the competence of the accountants. Consequently, the letter should state that the accountants make no representations regarding any matter of legal interpretation. Since the accountants will not be in a position to make any representations about the completeness or adequacy of disclosure or about the adequacy of the procedures followed, the

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<sup>19</sup> See paragraph .17 herein regarding requests by an underwriter for comments on interim financial information required by item 302(a) of SEC Regulation S-K and required supplementary information described in section 553. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

letter should so state. It should point out as well that such procedures would not necessarily disclose material misstatements or omissions in the information to which the comments relate. An appropriate manner of expressing the comments is shown in example I and example J.

## Concluding Paragraph

**.46** In order to avoid misunderstanding of the purpose and intended use of the comfort letter, it is desirable that the letter conclude with a paragraph along the following lines:

This letter is solely for the information of the addressees and to assist the underwriters<sup>20</sup> in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including, but not limited to, the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

## Miscellaneous

**.47** Accountants who discover matters that may require mention in the final comfort letter but that are not mentioned in the draft letter that has been furnished to the underwriter, such as decreases or changes in specified items not disclosed in the registration statement (see paragraphs .25 and .31), will naturally want to discuss them with their client so that consideration can be given to whether disclosure should be made in the registration statement. If disclosure is not to be made, the accountants should inform the client that the matters will be mentioned in the comfort letter and should suggest that the underwriter be promptly informed. It is recommended that the accountants be present when such matters are discussed between the client and the underwriter.

## Examples

**.48** The contents of letters for underwriters vary, depending on the extent of the information in the registration statement and the wishes of the underwriter. This section provides examples of letters for underwriters or portions of such letters. Shelf registration statements may have several closing dates and different underwriters. Descriptions of procedures and findings regarding interim financial statements, tables, statistics, or other financial information that is incorporated by reference from previous 1934 Act filings may have to be repeated in several comfort letters. To avoid restating these descriptions in each comfort letter, accountants may initially issue the comments in a format (such as an appendix) that can be referred to in, and attached to, subsequently issued comfort letters.

### Example A: Typical Letter

**.49** The following matters are covered in a typical comfort letter:

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<sup>20</sup> When the letter is furnished by the accountants for a subsidiary who are not accountants for the parent company, it should include at this point the following phrase: "and for the use of the accountants for [name of issuer] in furnishing their letter for the underwriters." [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

- a. A statement regarding the independence of the accountants (paragraph .13)
- b. An opinion regarding whether the audited financial statements and schedules included in the registration statement comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations (paragraphs .14 and .15).
- c. Negative assurance with respect to whether the unaudited condensed interim financial statements included in the registration statement (paragraphs .19 through .21)—
  - (i) Comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations
  - (ii) Are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements included in the registration statement
- d. Negative assurance with respect to whether, during a specified period following the date of the latest financial statements in the registration statement and prospectus, there has been any change in capital stock or long-term debt or any decrease in other specified financial statement items (paragraphs .19 and .25 through .30).

Example A is a letter covering all these items. Letters that cover some of the items may be developed by omitting inapplicable portions of example A.

Example A assumes the following circumstances.<sup>21</sup> The prospectus (part I of the registration statement) includes audited consolidated balance sheets as of December 31, 19X5 and 19X4, and audited consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. Part I also includes an unaudited consolidated condensed balance sheet as of March 31, 19X6, and unaudited consolidated condensed statements of income, retained earnings, and cash flows for the three-month periods ended March 31, 19X6 and 19X5, which were reviewed by the independent accountants and their review report was dated May 15, 19X6. Part II of the registration statement includes consolidated financial schedules for the three years ended December 31, 19X5 (audited). The effective date is June 23, 19X6. The cutoff date is June 25, 19X6, and the letter is dated June 30, 19X6.

Each of the comments in the letter is in response to a requirement of the underwriting agreement. For purposes of example A, the income statement items of the current interim period are to be compared with those of the corresponding period of the preceding year.

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<sup>21</sup> The example includes financial statements required by SEC regulations to be included in the filing. If additional financial information is covered by the comfort letter, appropriate modifications should be made. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

June 30, 19X6

[Addressee]

Dear Sirs:

We have audited the consolidated balance sheets of The Blank Company, Inc. (the company) and subsidiaries as of December 31, 19X5 and 19X4 and the consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5, and the related schedules all included in the registration statement (no. 2-00000) on Form S-1 filed by the company under the Securities Act of 1933 (the Act); our reports with respect thereto are also included in that registration statement. The registration statement, as amended on June 23, 19X6, is herein referred to as the registration statement.<sup>22</sup>

In connection with the registration statement—

1. We are independent certified public accountants with respect to The Blank Company, Inc., within the meaning of the Act and the applicable published rules and regulations thereunder.

2. In our opinion [include the phrase “except as disclosed in the registration statement,” if applicable], the consolidated financial statements and schedules audited by us and included in the registration statement comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations.

3. We have not audited any financial statements of the company as of any date or for any period subsequent to December 31, 19X5; although we have conducted an audit for the year ended December 31, 19X5, the purpose (and therefore the scope) of the audit was to enable us to express our opinion on the consolidated financial statements as of December 31, 19X5, and for the year then ended, but not on the financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited consolidated condensed balance sheet as of March 31, 19X6, and unaudited consolidated condensed statements of income, retained earnings, and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement, or on the financial position, results of operations, or cash flows as of any date or for any period subsequent to December 31, 19X5.

4. For purposes of this letter we have read the 19X6 minutes of meetings of the stockholders, the board of directors, and [include other appropriate committees, if any] of the company and its subsidiaries as set forth in the minute books at June 25, 19X6, officials of the company having advised us that the minutes of all such meetings through that date were set forth therein; and we have carried out other procedures to June 25, 19X6 (our work did not extend to the period from June 26, 19X6, to June 30, 19X6, inclusive), as follows:

a. With respect to the three-month periods ended March 31, 19X6 and 19X5, we have—

(i) Read the unaudited consolidated condensed balance sheet as of March 31, 19X6, and unaudited consolidated condensed statements

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<sup>22</sup> As described in paragraph .18, the accountants may refer in the introductory paragraphs to the fact that they have issued reports on other financial information. For example, if the accountants refer to the fact that a review of interim financial information had been performed, an additional introductory paragraph, such as the following, may be added.

Also, we have made a review of the unaudited consolidated condensed financial statements for the three-month periods ended March 31, 19X6 and 19X5, as indicated in our report dated May 15, 19X6, which is included [incorporated by reference] in the registration statement.

[Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

of income, retained earnings, and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement; and

- (ii) Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding (1) whether the unaudited consolidated condensed financial statements referred to in a(i) comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations and (2) whether those unaudited consolidated condensed financial statements are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement.
- b. With respect to the period from April 1, 19X6, to May 31, 19X6, we have—
  - (i) Read the unaudited consolidated financial statements of the company and subsidiaries for April and May of both 19X5 and 19X6 furnished us by the company, officials of the company having advised us that no such financial statements as of any date or for any period subsequent to May 31, 19X6, were available; and
  - (ii) Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding whether the unaudited financial statements referred to in b(i) are stated on a basis substantially consistent with that of the audited financial statements included in the registration statement.

The foregoing procedures do not constitute an audit conducted in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that—

- a. (i) The unaudited consolidated condensed financial statements described in 4a(i), included in the registration statement, do not comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations and (ii) the unaudited consolidated condensed financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements; or
- b. (i) At May 31, 19X6, there was any change in the capital stock or long-term debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown in the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement or (ii) for the period from April 1, 19X6, to May 31, 19X6 there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur.

6. As mentioned in 4b, company officials have advised us that no consolidated financial statements as of any date or for any period subsequent

to May 31, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after May 31, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have made inquiries of certain company officials who have responsibility for financial and accounting matters regarding whether (a) there was any change at June 25, 19X6, in the capital stock or long-term debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown on the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement or (b) for the period from April 1, 19X6, to June 25, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur.

7. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

### **Example B: Alternate Wording of the Letter for Companies That Are Permitted to Present Interim Earnings Data for a Twelve-Month Period**

.50 Certain types of companies are permitted to include earnings data for a twelve-month period to the date of the latest balance sheet furnished in lieu of earnings data for both the interim period between the end of the latest fiscal year and the date of the latest balance sheet and the corresponding period of the preceding fiscal year. The following would be substituted for the applicable part of numbered paragraph 3 of example A.

3. . . . was to enable us to express our opinion on the financial statements as of December 31, 19X5, and for the year then ended, but not on the financial statements for any period included in part within that year. Therefore, we are unable to and do not express any opinion on the unaudited consolidated condensed balance sheet as of March 31, 19X6, and the related unaudited consolidated condensed statements of income, retained earnings, and cash flows for the twelve months then ended included in the registration statement. . . .

### **Example C: Letter Reaffirming Comments in Example A as of a Later Date**

.51 If more than one comfort letter is requested, the later letter may, in appropriate situations, refer to information appearing in the earlier letter without repeating such information (see paragraphs .10 and .48). Example C reaffirms and updates the information in example A.

July 25, 19X6

[Addressee]

Dear Sirs:

We refer to our letter of June 30, 19X6, relating to the registration statement (no. 2-00000) of The Blank Company, Inc. (the company). We reaffirm as of the date hereof (and as though made on the date hereof) all statements made in that letter, except that, for the purposes of this letter—

- a. The registration statement to which this letter relates is as amended as of July 13, 19X6 [effective date].
- b. The reading of minutes described in paragraph 4 of that letter has been carried out through July 20, 19X6 [the new cutoff date].
- c. The procedures and inquiries covered in paragraph 4 of that letter were carried out to July 20, 19X6 [the new cutoff date] (our work did not extend to the period from July 21, 19X6, to July 25, 19X6 [date of letter], inclusive).
- d. The period covered in paragraph 4b of that letter is changed to the period from April 1, 19X6, to June 30, 19X6; officials of the company have advised us that the latest available financial statements are for the month of June 19X6.
- e. The references to May 31, 19X6, in paragraph 5b of that letter are changed to June 30, 19X6.
- f. The references to May 31, 19X6, and June 25, 19X6, in paragraph 6 of that letter are changed to June 30, 19X6, and July 20, 19X6, respectively.
- g. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

#### **Example D: Alternate Wording When the SEC Has Agreed to a Departure From Its Published Accounting Requirements**

.52 Example D is applicable when (a) there is a departure from the applicable accounting requirements of the Act and the related published rules and regulations and (b) representatives of the SEC have agreed to the departure. Numbered paragraph 2 of example A would be revised to read as follows:

2. In our opinion [include the phrase “except as disclosed in the registration statement,” if applicable], the financial statements and schedules audited by us and included or incorporated by reference in the registration statement comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations; however, as agreed to by representatives of the SEC, separate financial statements and schedules of ABC Company (an unconsolidated subsidiary) as required by Rule 3-09 of Regulation S-X have been omitted.



**Example E: Alternate Wording When Recent Earnings Data Are Presented in Capsule Form**

.53 Example E is applicable when (a) the statement of income in the registration statement is supplemented by later information regarding sales and earnings (capsule information) and (b) the accountants are asked to comment on that information (paragraph .22). The same facts exist as in example A, except for the following:

- a. Sales, net income (no extraordinary items), and earnings per share for the six-month periods ended June 30, 19X6 and 19X5 (both unaudited), are included in capsule form more limited than that specified by APB Opinion No. 28 [AC section I73].
- b. No financial statements later than those for June 19X6 are available.
- c. The letter is dated July 25, 19X6, and the cutoff date is July 20, 19X6.

Numbered paragraphs 4, 5, and 6 of example A should be revised to read as follows:

4. For purposes of this letter we have read the 19X6 minutes . . . and have carried out other procedures to July 20, 19X6 (our work did not extend to the period from July 21, 19X6, to July 25, 19X6, inclusive) with respect to the six-month periods ended June 30, 19X6, and 19X5, as follows:

- a. Read the unaudited consolidated condensed balance sheet as of March 31, 19X6, and the unaudited consolidated condensed statements of income, retained earnings, and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement.
- b. Read the unaudited amounts for sales, net income, and earnings per share for the six-month periods ended June 30, 19X6 and 19X5, as set forth in the paragraph [identify location] and read the unaudited consolidated financial statements furnished us by the company for those periods, from which those amounts were derived.
- c. Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding (i) whether the unaudited consolidated condensed financial statements referred to in a comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations, (ii) whether those unaudited consolidated condensed financial statements are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement, and (iii) whether the unaudited amounts referred to in b are stated on a basis substantially consistent with that of the corresponding amounts in the audited consolidated statements of income.

The foregoing procedures do not constitute an audit conducted in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that—

- a. (i) The unaudited consolidated condensed financial statements described in 4a, included in the registration statement, do not comply in form in all material respects with the applicable accounting requirements of the Act and the related published rules and regulations or (ii) those unaudited consolidated condensed financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements;
- b. The unaudited sales and net income amounts, referred to in 4b, (i) do not agree with the amounts set forth in the unaudited consolidated financial statements for those same periods or (ii) were not determined on a basis substantially consistent with that of the corresponding amounts in the audited consolidated statements of income; or
- c. At June 30, 19X6, there was any change in the capital stock or long-term debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown in the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement, except for changes or decreases that the registration statement discloses have occurred or may occur.

6. Company officials have advised us that no consolidated financial statements as of any date or for any period subsequent to June 30, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after June 30, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have made inquiries of certain company officials who have responsibility for financial and accounting matters regarding whether (a) at July 20, 19X6, there was any change in the capital stock or long-term debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown on the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement; or (b) for the period from July 1, 19X6, to July 20, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur.

### **Example F: Alternate Wording When Accountants Are Aware of a Decrease in a Specified Financial Statement Item**

.54 Example F covers a situation in which the accountants are aware of a decrease in a financial statement item on which they are requested to comment (paragraphs .25 through .30). The same facts exist as in example A, except for the decrease covered in the following change in numbered paragraph 5b.

- b. (i) At May 31, 19X6, there was any change in the capital stock or long-term debt of the company and subsidiaries consolidated or any decrease in consolidated net assets as compared with amounts shown in the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement or (ii) for the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as

compared with the corresponding period in the preceding year, in consolidated net sales or the total or pershare amounts of income before extraordinary items or net income, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur except that the unaudited consolidated balance sheet as of May 31, 19X6, which we were furnished by the company, showed a decrease from March 31, 19X6, in consolidated net current assets as follows (in thousands of dollars):

	<u>Current Assets</u>	<u>Current Liabilities</u>	<u>Net Current Assets</u>
March 31, 19X6	\$4,251	\$1,356	\$2,895
May 31, 19X6	3,986	1,732	2,254

6. As mentioned in 4*b*, company officials have advised us that no consolidated financial statements as of any date or for any period subsequent to May 31, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after May 31, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have made inquiries of certain company officials who have responsibility for financial and accounting matters regarding whether (a) there was any change at June 25, 19X6, in the capital stock or longterm debt of the company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown on the March 31, 19X6, unaudited consolidated condensed balance sheet included in the registration statement; or (b) for the period from April 1, 19X6, to June 25, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or pershare amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur and except as described in the following sentence. We have been informed by officials of the company that there continues to be a decrease in net current assets that is estimated to be approximately the same amount as set forth in 5*b* [or whatever other disclosure fits the circumstances].

### **Example G: Alternate Wording When Accountants' Opinion Contains a Qualification**

.55 [Example deleted to reflect the conforming changes necessary to the issuance of SAS Nos. 53 through 62.]

### **Example H: Alternate Wording When More Than One Accountant Is Involved**

.56 Example H applies when more than one accountant is involved in the audit of the financial statements of a business and the principal accountants have obtained a copy of the comfort letter of the other accountants (paragraph .37). Example H consists of an addition of a subparagraph *c* to numbered paragraph 4, a substitution for the applicable part of numbered paragraph 5, and an addition to numbered paragraph 6 of example A.

[4] *c*. We have read the letter dated \_\_\_\_\_ of [the other accountants] with regard to [the related company].

5. Nothing came to our attention as a result of the foregoing procedures (which, so far as [the related company] is concerned, consisted solely of reading the letter referred to in 4*c*), however, that caused us to believe that

...

6. . . . On the basis of these inquiries and our reading of the minutes and the letter dated \_\_\_\_\_ of [the other accountants] with regard to [the related company], as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases that the registration statement discloses have occurred or may occur.

### Example I: Comments on Tables, Statistics, and Other Financial Information

.57 Example I is applicable when the accountants are asked to comment on tables, statistics, or other compilations of information appearing in a registration statement (paragraphs .40 through .45). Each of the comments is in response to a specific request. The paragraphs in example I are intended to follow numbered paragraph 6 in example A.

7. For purposes of this letter, we have also read the following, set forth in the registration statement on the indicated pages.<sup>23</sup>

<i>Item</i>	<i>Page</i>	<i>Description</i>
<i>a</i>	4	"Capitalization." The amounts under the captions "Amount Outstanding as of June 15, 19X6" and "As Adjusted." The related notes, except the following in Note 2: "See 'Transactions With Interested Persons.' From the proceeds of this offering the company intends to prepay \$900,000 on these notes, pro rata. See 'Use of Proceeds.'"
<i>b</i>	13	"History and Business—Sales and Marketing." The table following the first paragraph.
<i>c</i>	22	"Executive Compensation—19X5 Compensation." The dollar amounts shown in the table "Cash Compensation" and under the headings "Compensation Pursuant to Plans," "Stock Options," and "Other Compensation."
<i>d</i>	33	"Selected Financial Data." <sup>24</sup> The amounts of net sales, income from continuing operations, income from continuing operations per common share, total assets, long-term obligations, redeemable preferred stock, and cash dividends declared per common share for each of the five years in the period ended December 31, 19X5.

8. Our audit of the consolidated financial statements for the periods referred to in the introductory paragraph of this letter comprised audit tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. For none of the periods referred to therein nor any other period did we perform audit tests for the purpose of expressing an opinion on individual balances of accounts or summaries of selected transactions such as those enumerated above, and, accordingly, we express no opinion thereon.

9. However, for purposes of this letter we have performed the following additional procedures, which were applied as indicated with respect to the items enumerated above.

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<sup>23</sup> In some cases it may be considered desirable to combine in one paragraph the substance of paragraphs 7 and 9. This may be done by expanding the identification of items in paragraph 9 to provide the identification information contained in paragraph 7. In such cases, the introductory sentences in paragraphs 7 and 9 and the text of paragraph 8 might be combined as follows:

For purposes of this letter, we have also read the following information and have performed the additional procedures stated below with respect to such information. Our audit of the consolidated financial statements . . .

[Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<sup>24</sup> In some cases the company or the underwriters may request that the independent accountants report on "selected financial data" as described in section 552. When the accountants report on this data and the report is included in the registration statement, separate comments should not be included in the comfort letter (see paragraph .18). [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

*Item**in 7**Procedures and Findings*

- a. We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" with the balances in the appropriate accounts in the company's general ledger at May 31, 19X6 (the latest date for which postings had been made), and found them to be in agreement. We were informed by company officials responsible for financial and accounting matters that there had been no changes in such amounts and numbers of shares between May 31, 19X6, and June 15, 19X6. We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" adjusted for the issuance of the debentures to be offered by means of the registration statement and for the proposed use of a portion of the proceeds thereof to prepay portions of certain notes, as described under "Use of Proceeds," with the amounts and numbers of shares shown under the caption "As Adjusted" and found such amounts and numbers of shares to be in agreement. (However, we make no comments regarding the reasonableness of the "Use of Proceeds" or whether such use will actually take place.) We compared the description of the securities and the information (except certain information in Note 2, referred to in 7) included in the notes to the table with the corresponding descriptions and information in the company's consolidated financial statements, including the notes thereto included in the registration statement, and found such descriptions and information to be in agreement.
- b. We compared the amounts of military sales, commercial sales, and total sales shown in the registration statement with the balances in the appropriate accounts in the company's general ledger for the respective fiscal years and for the unaudited interim periods and found them to be in agreement. (However, we make no comments regarding the appropriateness of such classification or the manner in which such classification has been made.) We computed the approximate percentages of such amounts of military sales and commercial sales to total sales for the respective fiscal years and for the unaudited interim periods. We compared the computed percentages with the corresponding percentages appearing in the registration statement and found them to be in agreement.
- c. We compared the dollar amounts of cash compensation for each listed individual with the corresponding amounts shown by the individual employee earnings records for the year 19X5 and found them to be in agreement. We compared the dollar amount of aggregate executive officers' cash compensation with the corresponding amount shown in an analysis prepared by the company and found the amounts to be in agreement.

We compared the dollar amounts of compensation pursuant to plans, stock options, and other compensation for each listed individual and the aggregate amounts for executive officers with corresponding amounts shown in an analysis prepared by the company and found such amounts to be in agreement. However, we make no comment regarding the completeness or appropriateness of the company's determination of what constitutes executive compensation for purposes of the SEC disclosure requirements on executive compensation.

*Item**in 7**Procedures and Findings*

- d. We compared the amounts of net sales, income from continuing operations, income from continuing operations per common share, and cash dividends declared per common share for the years ended December 31, 19X5, 19X4, and 19X3, to the consolidated financial statements on pages 27 and 28 and the amounts for the years ended December 31, 19X2 and 19X1, to the consolidated financial statements included in the company's annual reports to stockholders for 19X2 and 19X1 and found them to be in agreement.

We compared the amounts of total assets, long-term obligations, and redeemable preferred stock at December 31, 19X5 and 19X4, with the consolidated financial statements on pages 27 and 28 and the amounts at December 31, 19X3, 19X2, and 19X1, to the corresponding amounts in the consolidated financial statements included in the company's annual reports to stockholders for 19X3, 19X2, and 19X1, and found them to be in agreement.

10. It should be understood that we make no representations regarding questions of legal interpretation or regarding the sufficiency for your purposes of the procedures enumerated in the preceding paragraph; also, such procedures would not necessarily reveal any material misstatement of the amounts or percentages listed above. Further, we have addressed ourselves solely to the foregoing data as set forth in the registration statement and make no representations regarding the adequacy of disclosure or regarding whether any material facts have been omitted.

11. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

### **Example J: Summarized Description of Procedures and Findings Regarding Tables, Statistics, and Other Financial Information**

.58 Example J illustrates in paragraph 9a a method of summarizing the descriptions of procedures and findings regarding tables, statistics, and other financial information in order to avoid repetition in the comfort letter. The summarization of the descriptions is permitted by paragraph .43. Each of the comments is in response to a specific request. The paragraphs in example J are intended to follow numbered paragraph 6 in example A.<sup>25</sup>

7. For purposes of this letter, we have also read the following, set forth in the registration statement on the indicated pages.

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<sup>25</sup> Other methods of summarizing the descriptions may also be appropriately used. For example, the letter may present a matrix listing the financial information and common procedures employed and indicating the procedures applied to specific items. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

<u>Item</u>	<u>Page</u>	<u>Description</u>
a	4	"Capitalization." The amounts under the captions "Amount Outstanding as of June 15, 19X6" and "As Adjusted." The related notes, except the following in Note 2: "See 'Transactions With Interested Persons.' From the proceeds of this offering the company intends to prepay \$900,000 on these notes, pro rata. See 'Use of Proceeds.'"
b	13	"History and Business—Sales and Marketing." The table following the first paragraph.
c	22	"Executive Compensation—19X5 Compensation." The dollar amounts shown in the table "Cash Compensation" and under the headings "Compensation Pursuant to Plans," "Stock Options," and "Other Compensation."
d	33	"Selected Financial Data." <sup>26</sup> The amounts of net sales, income from continuing operations, income from continuing operations per common share, total assets, long-term obligations, redeemable preferred stock, and cash dividends declared per common share for each of the five years in the period ended December 31, 19X5.

8. Our audit of the consolidated financial statements for the periods referred to in the introductory paragraph of this letter comprised audit tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. For none of the periods referred to therein nor any other period did we perform audit tests for the purpose of expressing an opinion on individual balances of accounts or summaries of selected transactions such as those enumerated above, and, accordingly, we express no opinion thereon.

9. However, for purposes of this letter and with respect to the items enumerated in 7 above—

- a. Except for item 7a, we have (i) compared the dollar amounts either to the amounts in the audited consolidated financial statements described in the introductory paragraph of this letter or, for prior years, included in the company's annual report to stockholders for the years 19X1, 19X2, and 19X3 or to amounts in the unaudited consolidated financial statements described in paragraph 3 to the extent such amounts are included in or can be derived from such statements and found them to be in agreement; (ii) compared the amounts of military sales, commercial sales, and total sales and the dollar amounts of cash compensation for each listed individual to amounts in the company's accounting records and found them to be in agreement; (iii) compared other dollar amounts to amounts in analyses prepared by the company and found them to be in agreement; and (iv) proved the arithmetic accuracy of the percentages based on the data in the above-mentioned financial statements, accounting records, and analyses. With respect to item 7b, we make no comments regarding the appropriateness of the classification of military and commercial sales or the manner in which such classification has been made. With respect to item 7c, we make no comment regarding the completeness or appropriateness of the company's determination of what constitutes executive compensation for purposes of the SEC disclosure requirements on executive compensation.
- b. With respect to item 7a, we compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" with the balances in the appropriate accounts in the company's general ledger at May 31, 19X6 (the latest date for which postings had been made), and found them to be in agreement. We

<sup>26</sup> See footnote 24. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

were informed by company officials responsible for financial and accounting matters that there had been no changes in such amounts and numbers of shares between May 31, 19X6, and June 15, 19X6. We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" adjusted for the issuance of the debentures to be offered by means of the registration statement and for the proposed use of a portion of the proceeds thereof to prepay portions of certain notes, as described under "Use of Proceeds," with the amounts and numbers of shares shown under the caption "As Adjusted" and found such amounts and numbers of shares to be in agreement. (However, we make no comments regarding the reasonableness of "Use of Proceeds" or whether such use will actually take place.) We compared the description of the securities and the information (except certain information in Note 2, referred to in 7) included in the notes to the table with the corresponding descriptions and information in the company's consolidated financial statements, including the notes thereto, included in the registration statement and found such descriptions and information to be in agreement.

10. It should be understood that we make no representations regarding questions of legal interpretation or regarding the sufficiency for your purposes of the procedures enumerated in the preceding paragraph; also, such procedures would not necessarily reveal any material misstatement of the amounts or percentages listed above. Further, we have addressed ourselves solely to the foregoing data as set forth in the registration statement and make no representations regarding the adequacy of disclosure or regarding whether any material facts have been omitted.

11. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

### **Example K: Letter When a Short-Form Registration Statement Is Filed Incorporating Previously Filed Forms 10-K and 10-Q by Reference**

.59 Example K is applicable when a registrant uses a short-form registration statement (Form S-2 or S-3), which, by reference, incorporates previously filed Forms 10-K and 10-Q. It assumes that the short-form registration statement and prospectus include the Form 10-K for the year ended December 31, 19X5, and Form 10-Q for the quarter ended March 31, 19X6, which have been incorporated by reference. In addition to the information presented below, the letter would also contain paragraphs 6 and 7 of the typical letter in example A.

June 30, 19X6

[Addressee]

Dear Sirs:

We have audited the consolidated balance sheets of The Blank Company, Inc. (the company) and subsidiaries as of December 31, 19X5 and 19X4, and the consolidated statements of income, retained earnings, and cash flows for



each of the three years in the period ended December 31, 19X5, and the related schedules, all included [or incorporated by reference] in the company's annual report on Form 10-K for the year ended December 31, 19X5, and incorporated by reference in the registration statement (no. 2-00000) on Form S-3 filed by the company under the Securities Act of 1933 (the Act); our report with respect thereto is also incorporated by reference in that registration statement. The registration statement, as amended on May 31, 19X6, is herein referred to as the registration statement.

In connection with the registration statement—

1. We are independent certified public accountants with respect to the company within the meaning of the Act and the applicable published rules and regulations thereunder.

2. In our opinion, the consolidated financial statements and schedules audited by us and incorporated by reference in the registration statement comply in form in all material respects with the applicable accounting requirements of the Act and the Securities Exchange Act of 1934 and the related published rules and regulations.

3. We have not audited any financial statements of the company as of any date or for any period subsequent to December 31, 19X5; although we have conducted an audit for the year ended December 31, 19X5, the purpose (and therefore the scope) of the audit was to enable us to express our opinion on the consolidated financial statements as of December 31, 19X5, and for the year then ended but not on the consolidated financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited consolidated condensed balance sheet as of March 31, 19X6, and the unaudited consolidated condensed statements of income, retained earnings, and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the company's quarterly report on Form 10-Q for the quarter ended March 31, 19X6, incorporated by reference in the registration statement, or on the financial position, results of operations, or cash flows as of any date or for any period subsequent to December 31, 19X5.

4. For purposes of this letter, we have read the 19X6 minutes of the meetings of the stockholders, board of directors, and [include other appropriate committees, if any] of the company and its subsidiaries as set forth in the minute books at June 25, 19X6, officials of the company having advised us that the minutes of all such meetings through that date were set forth therein, and have carried out other procedures to June 25, 19X6 (our work did not extend to the period from June 26, 19X6, to June 30, 19X6, inclusive), as follows:

- a. With respect to the three-month periods ended March 31, 19X6 and 19X5, we have—
  - (i) Read the unaudited consolidated condensed financial statements for these periods, described in 3, included in the company's quarterly report on Form 10-Q for the quarter ended March 31, 19X6, incorporated by reference in the registration statement.
  - (ii) Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding (1) whether the unaudited consolidated condensed financial statements referred to in a(i) comply in form in all material respects with the applicable accounting requirements of the Securities Exchange Act of 1934 as it applies to Form 10-Q and the related published rules and regulations and (2) whether those unaudited consolidated condensed financial statements are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements incorporated by reference in the registration statement.

- b. With respect to the period from April 1, 19X6, to May 31, 19X6, we have—
  - (i) Read the unaudited consolidated financial statements of the company and subsidiaries for April and May of both 19X5 and 19X6 furnished us by the company, officials of the company having advised us that no such financial statements as of any date or for any period subsequent to May 31, 19X6, were available; and
  - (ii) Made inquiries of certain officials of the company who have responsibility for financial and accounting matters regarding whether the unaudited consolidated financial statements referred to in *b(i)* are stated on a basis substantially consistent with that of the audited consolidated financial statements incorporated by reference in the registration statement.

The foregoing procedures do not constitute an audit conducted in accordance with generally accepted auditing standards. In addition, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations about the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that—

- a. (i) The unaudited consolidated condensed financial statements described in 3, incorporated by reference in the registration statement, do not comply in form in all material respects with the applicable accounting requirements of the Securities Exchange Act of 1934 as it applies to Form 10-Q and the related published rules and regulations; or (ii) the unaudited consolidated condensed financial statements are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements incorporated by reference in the registration statement; or
- b. (i) At May 31, 19X6, there was any change in the capital stock or long-term debt of the company and consolidated subsidiaries or any decreases in consolidated net current assets or net assets as compared with amounts shown in the March 31, 19X6, unaudited consolidated condensed balance sheet incorporated by reference in the registration statement; or (ii) for the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances of changes or decreases that the registration statement discloses have occurred or may occur.

### **Example L: Comments on Pro Forma Financial Information**

.60 Example L is applicable when the accountants are asked to comment on (a) compliance as to form of pro forma financial information in a registration statement with applicable accounting requirements of published rules and regulations of the SEC and (b) the application of pro forma adjustments to historical amounts in the compilation of the pro forma financial information (see paragraph .19g). The material in this example is intended to be inserted between numbered paragraphs 6 and 7 in example A. The example assumes that the accountants have not previously reported on the pro forma financial information. If the accountants did previously report on the pro forma financial information, they may refer in the introductory paragraphs of the comfort letter to the fact that they have issued a report, and the report may be

attached to the comfort letter (see paragraph .18). In that circumstance, therefore, the procedures in 7b(i) and 7c ordinarily would not be performed, and the accountants should not separately comment on the application of pro forma adjustments in the compilation of the pro forma financial information since that assurance is encompassed in the accountants' report on pro forma financial information attached to the comfort letter. The accountants may, however, agree to comment on compliance as to form with applicable accounting requirements of published rules and regulations of the SEC.

7. We are unable to and do not express any opinion on such unaudited pro forma consolidated condensed financial statements referred to in 7a or on the pro forma adjustments applied to the historical amounts included in those statements. However, for purposes of this letter and at your request, we have—

- a. Read the unaudited pro forma consolidated condensed balance sheet as of March 31, 19X6, and the unaudited pro forma consolidated condensed statements of income for the year ended December 31, 19X5, and the three-month period ended March 31, 19X6, included [incorporated by reference] in the registration statement.
- b. Made inquiries of certain officials of the company and of XYZ Company (the company being acquired) who have responsibility for financial and accounting matters about—
  - (i) The basis for their determination of the pro forma adjustments, and
  - (ii) Whether the unaudited pro forma consolidated condensed financial statements referred to in 7a comply in form in all material respects with the applicable accounting requirements of Rule 11-02 of Regulation S-X.
- c. Proved the arithmetic accuracy of the application of the pro forma adjustments to the historical amounts in the unaudited pro forma consolidated condensed financial statements.

The foregoing procedures would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representation about the sufficiency of such procedures for your purposes.

8. Nothing came to our attention as a result of the procedures specified in paragraph 7, however, that caused us to believe that the unaudited pro forma consolidated condensed financial statements referred to in 7a included [incorporated by reference] in the registration statement do not comply in form in all material respects with the applicable accounting requirements of Rule 11-02 of Regulation S-X and that the pro forma adjustments have not been properly applied to the historical amounts in the compilation of those statements.

## Effective Date

.61 This section is effective for letters for underwriters dated on or after October 31, 1984. Earlier application is encouraged.

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[The next page is 1161.]

## AU Section 9634

### ***Letters for Underwriters: Auditing Interpretations of Section 634***

#### **1. Letters to Directors Relating to Annual Reports on Form 10-K \***

**.01 Question**—Annual reports to the Securities and Exchange Commission (SEC) on Form 10-K must be signed by at least a majority of the registrant's board of directors. In reviewing the Form 10-K, directors may seek the involvement of the registrant's independent auditors and other professionals.

**.02** What types of services could the auditor perform at the request of the board of directors in connection with the Form 10-K? For example, is it permissible for an auditor to comment in the form of negative assurance concerning the compliance of the registrant's Form 10-K with the requirements of the various SEC rules and regulations? <sup>1</sup>

**.03 Interpretation**—The auditor can express an opinion to the board of directors on whether the financial statements and schedules audited by him comply as to form with the applicable accounting requirements of the Securities Exchange Act of 1934 and the published rules and regulations thereunder.<sup>2</sup> Except with respect to requirements for financial statements and schedules, the question of what constitutes appropriate information for compliance with the requirements of a particular item of Form 10-K generally involves matters of legal interpretation not within the professional capabilities of independent auditors. Accordingly, the auditor should not express negative assurance concerning the compliance with SEC requirements of information not covered by the auditor's report.

**.04** The auditor may affirm to the board of directors that under generally accepted auditing standards the auditor is required to read the information in addition to audited financial statements contained in the Form 10-K, for the purpose of considering whether such information may be materially inconsistent with information appearing in the financial statements. (See section 550.) However, the report to the board of directors should state that the auditor has no obligation to perform any procedures to corroborate such information.

**.05** In addition, the auditor could perform at the request of the board of directors specified procedures and report his findings concerning various information contained in the Form 10-K such as tables, statistics and other

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\* [Formerly section 9630.1—.19, as modified by issuance of Statement on Auditing Standards No. 38, *Letters for Underwriters*, April, 1981 (superseded). Formerly section 9631.01—.09, changed to section 9634.01—.09 by issuance of Statement on Auditing Standards No. 49, *Letters for Underwriters*, September, 1984.] (See section 634.)

<sup>1</sup> Negative assurance consists of a statement by auditors to the effect that nothing came to their attention as a result of specified procedures that caused them to believe that specified matters do not meet a specified standard.

<sup>2</sup> The auditor should not provide any assurance on compliance with the provisions of the Securities Exchange Act of 1934 regarding internal control structure policies and procedures. See the October 1978 auditing interpretation, "Compliance with the Foreign Corrupt Practices Act of 1977" (AU section 9642.10—.13).

financial information provided there is a clear understanding with the Board as to the nature, extent and limitations of the procedures to be performed and as to the kind of report to be issued. The guidance provided in section 634 is intended primarily for the auditor issuing a letter to underwriters in connection with a registration statement filed under the Securities Act of 1933. However, much of the guidance in paragraphs .40 through .45 of section 634 would also be applicable when the auditor is asked to furnish a letter to the board of directors in connection with the filing of Form 10-K under the Securities Exchange Act of 1934.<sup>3</sup> [References changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

**.06** The types of information on which the auditor may comment are described in section 634.41. In general, the auditor should comment only on information that has been obtained from financial statements or accounting records subject to the client's internal control structure policies and procedures, or derived directly from such reports by analysis or computation. The comments should be made in the form of descriptions of the procedures followed and of the auditor's findings, ordinarily expressed in terms of agreement between items compared. [Reference changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

**.07** The auditor should not comment on matters that are primarily subjective or judgmental in nature such as those included in Item 7 of Form 10-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations." For example, changes between periods in gross profit ratios may be caused by factors that are not necessarily within the expertise of auditors. In addition, the discussion may contain certain forward-looking information for which it generally would be inappropriate for the auditor to provide any form of assurance. However, the auditor can comment on specific changes in comparative amounts that are included in management's discussion if the amounts used to compute such changes are obtained from the financial statements or accounting records as discussed above, but cannot comment with respect to the appropriateness of the explanations.

**.08** There are no criteria by which to measure the sufficiency of the procedures performed by the auditor for the directors' purposes. Ordinarily, the auditor should discuss with the directors or the audit committee the procedures to be followed and may suggest procedures that might be meaningful in the circumstances. However, the auditor should clearly indicate to the board of directors that the auditor cannot make any representations as to whether the agreed-upon procedures are sufficient for the directors' purposes.

**.09** It should not ordinarily be necessary for the auditor to reaffirm his independence to the board of directors. If such a representation is requested, however, the auditor may include in his letter a paragraph as follows:

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<sup>3</sup> Section 634.02 states in part: "Accountants will normally be willing to assist the underwriter, but the assistance accountants can provide by way of comfort letters is subject to limitations. One limitation is that an independent accountant can properly comment in his professional capacity only on matters to which his professional expertise is substantially relevant." [Reference changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

[We are independent certified public accountants with respect to the Company within the meaning of the Securities Exchange Act of 1934 and the applicable published rules and regulations thereunder.]

[Issue Date: April, 1981; modified: May, 1981.]

## **2. Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters**

**.10 Question**—Section 634, *Letters for Underwriters*, paragraph .24, states that unaudited condensed interim financial statements for a period ending after the latest financial statements included in a registration statement should be attached to a comfort letter when an accountant gives negative assurance on the unaudited condensed interim financial statements. The negative assurance referred to in paragraph .24 could relate to negative assurance that the unaudited condensed interim financial statements are in conformity with generally accepted accounting principles or that these financial statements are stated on a basis substantially consistent with the audited financial statements included in the registration statement. It could also relate to negative assurance regarding changes in specified financial statement items derived from interim financial statements not included in the registration statement when such specified financial statement items are compared with similar information in the corresponding-period prior-year financial statements. Does the negative assurance in paragraph .24 relate to all of these situations or only specific situations?

**.11 Interpretation**—In the situations described in section 634.24, negative assurance relates to negative assurance that unaudited condensed interim financial statements for a period ending after the latest financial statements included in the registration statement, including financial statements that underlie capsule information, are in conformity with generally accepted accounting principles or are stated on a basis substantially consistent with the audited financial statements included in the registration statement. The unaudited condensed interim financial statements referred to in these situations should be attached to the comfort letter.

**.12** Section 634.24 does not relate to negative assurance regarding changes in specified financial statement items. Section 634, paragraphs .25 through .31 provide guidance in these situations.

[Issue Date: July, 1986.]

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[The next page is 1201.]

## AU Section 642

### ***Reporting on Internal Accounting Control***

The concepts of section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*, have a considerable effect on considerations auditors should make in reporting on the internal accounting control of an entity. The Auditing Standards Board is developing guidance to amend section 642, *Reporting on Internal Accounting Control*, that will, among other things, relate the concepts of section 642 with those of section 319. An exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, which would supersede section 642, has been issued.

(Supersedes sections 640, "Reports on Internal Control," and 641, "Reports on Internal Control Based on Criteria Established by Governmental Agencies.")

Source: SAS No. 30.

See section 9642 for interpretations of this section.

Issue date, unless otherwise indicated: July, 1980.

.01 This section describes the procedures an independent accountant should apply in connection with various types of engagements to report on an entity's system of internal accounting control, and it describes the different forms of the accountant's report to be issued in connection with such engagements.<sup>1</sup>

.02 An independent accountant may be engaged to report on an entity's system of internal accounting control in several ways. The accountant may be engaged to

- a. Express an opinion on the entity's system of internal accounting control in effect as of a specified date (paragraphs .03 through .46). (An accountant may also be engaged to express an opinion on the entity's system of internal accounting control in effect during a

[The next page is 1201-3.]

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<sup>1</sup> The auditor's study and evaluation of internal accounting control in an examination of an entity's financial statements is discussed in section 320. The guidance in this section is generally applicable also to engagements to report on internal accounting control. This section provides (1) additional guidance concerning matters that are unique to engagements to report on internal accounting control and (2) a further discussion of certain related matters in section 320. This section amends section 320.77 and sections 323.01, 323.08, and 323.09. See the Appendix at paragraph .62 for the revised wording. [Reference number 320.72, formerly 320.68, changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference number 320.77, formerly 320.72, changed by the issuance of Statement on Auditing Standards No. 48.]

specified period of time; in which case, the guidance in such paragraphs should be adapted as appropriate.)

- b. Report on the entity's system, for the restricted use of management, specified regulatory agencies, or other specified third parties, based solely on a study and evaluation of internal accounting control made as part of an audit of the entity's financial statements that is not sufficient for expressing an opinion on the system.<sup>2</sup>
- c. Report on all or part of entity's system, for the restricted use of management or specified regulatory agencies, based on the regulatory agencies' pre-established criteria (paragraphs .54 through .59).
- d. Issue other special-purpose reports on all or part of an entity's system for the restricted use of management, specified regulatory agencies, or other specified third parties (paragraphs .60 and .61).

An accountant may also be involved with an entity's system of internal accounting control in ways that do not involve reporting in accordance with this section. For example, an accountant may be engaged to consult on improving the system. In these circumstances the accountant may communicate the results of his engagement by letters, memoranda, and other less formal means solely for the internal information of management.<sup>[\*]</sup>

## Expression of an Opinion on an Entity's System of Internal Accounting Control

.03 This section [paragraphs .03—.46] describes the general considerations, the study and evaluation, and the form of the accountant's report applicable to an engagement to express an opinion on an entity's system of internal accounting control. The accountant does not need to place any restrictions on the use of this report.

### General Considerations

#### The Objectives of Internal Accounting Control

.04 The broad objectives of internal accounting control, as defined in section 320.27 (see Appendix G), are to provide management with reasonable, but not absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial records are reliable to permit the preparation of financial statements. The definition also sets forth the following operative objectives that are necessary to achieve the broad objectives:

- a. Transactions are executed in accordance with management's general or specific authorization.
- b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- c. Access to assets is permitted only in accordance with management's authorization.

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<sup>2</sup> As the terms are used in this section, *management* includes directors, officers, and others who perform managerial functions, and *regulatory agencies* include governmental and other agencies, such as stock exchanges, that exercise regulatory, supervisory, or other public administrative functions.

<sup>[\*]</sup> Footnote deleted, June 1992, by the issuance of SAS No. 70.



- d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

[Reference changed by the issuance of Statement on Auditing Standards No. 48.]

**.05** In the context of internal accounting controls, *safeguarding of assets* refers only to protection against loss arising from errors and irregularities in

processing transactions and handling the related assets.<sup>3</sup> It does not include the loss of assets arising from management's operating business decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that later prove to be unnecessary or unsatisfactory, authorizing what turns out to be unproductive research or ineffective advertising, or accepting some level of customer pilferage of merchandise as part of operating a retail business.

**.06** The objective concerning the reliability of financial records relates to financial statements regularly released to users outside the entity. This would include annual financial statements, interim financial statements, and summarized financial data derived from such statements.

**.07** The preparation of financial statements requires the use of estimates and judgments, and internal accounting control includes controls relating to those estimates and judgments. The nature of such controls, however, differs from that of controls relating to the execution and recording of transactions and to the safeguarding of assets. Estimates and judgments are necessarily subjective and relate largely to future conditions and events; accordingly, internal accounting controls relating to estimates and judgments are limited to those procedures designed to provide reasonable assurance that individuals at appropriate levels in the organization review and consider sufficient, reliable information in making the required estimates and judgments.

#### **Limitations**

**.08** There are inherent limitations, discussed in section 320.35, that should be recognized in considering the potential effectiveness of any system of internal accounting control. Particularly significant for the purpose of reports on internal accounting control is "any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with prescribed procedures may deteriorate." [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

#### **Relationship to the Study and Evaluation Made in an Audit**

**.09** An engagement to express an opinion on an entity's system of internal accounting control and a study and evaluation of internal accounting controls made as part of an examination of financial statements in accordance with generally accepted auditing standards differ in purpose and generally differ in scope. While the former can be made in conjunction with the latter, an engagement to express an opinion on the system of internal accounting control can be made as of a different date or by a different accountant as long as the accountant obtains the necessary understanding of the entity's operations (see paragraph .14).

**.10** The purpose of an engagement to express an opinion on an entity's system of internal accounting control differs from the purpose of the study and evaluation of internal accounting controls made as part of an audit. The auditor's study and evaluation of internal accounting control is an intermediate step in forming an opinion on the financial statements. It establishes a basis for determining the extent to which auditing procedures are to be restricted and assists the auditor in planning and performing his examination.

<sup>3</sup> A note to section 320.37 specifies that "errors" refers to unintentional mistakes, and "irregularities" refers to intentional distortions of financial statements and to defalcations." [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

In an audit, the auditor may decide not to rely on prescribed control procedures because he concludes either (a) that the procedures are not satisfactory for his purposes or (b) that the audit effort required to test compliance with the procedures to justify reliance on them would exceed the reduction in effort that could be achieved by such reliance. Accordingly, the study and evaluation of the system of internal accounting control in an audit is generally more limited than that made in connection with an engagement to express an opinion on the system of internal accounting control. Nevertheless, an accountant's opinion on a system of internal accounting control does not increase the reliability of financial statements that have been audited.

.11 Although the scope of the study and evaluation of internal accounting controls in an engagement to express an opinion on the system of internal accounting control generally differs from that of an audit, the procedures are similar in nature. Thus, the study and evaluation made in connection with an engagement to express an opinion on the system may also serve as a basis for reliance on internal accounting controls in determining the nature, timing, and extent of audit tests. Furthermore, an accountant need not apply procedures in an audit that duplicate procedures that have been applied for the purpose of expressing an opinion on an entity's system of internal accounting control.

#### **Relationship to the Foreign Corrupt Practices Act**

.12 The Foreign Corrupt Practices Act of 1977 (FCPA) includes provisions regarding internal accounting control for companies subject to the Securities Exchange Act of 1934. Whether a company is in compliance with those provisions of the FCPA is a legal determination. An independent accountant's opinion does not indicate whether the company is in compliance with those provisions but may be helpful to management in evaluating the company's compliance.

### **The Study and Evaluation**

.13 In making a study and evaluation for the purpose of expressing an opinion on an entity's system of internal accounting control in effect as of a specified date, the accountant should (a) plan the scope of the engagement, (b) review the design of the system, (c) test compliance with prescribed procedures, and (d) evaluate the results of his review and tests.

#### **Planning the Scope of the Engagement**

.14 *General considerations.* Among the factors to be considered in planning the scope of the engagement are

- a. The nature of the entity's operations, including the susceptibility of assets to unauthorized use or misappropriation in light of their mobility or salability and the nature and volume of transactions.
- b. The overall control environment, including
  1. The entity's organizational structure, including the duties and authority of the board of directors and its audit committee (or comparable bodies), senior management, and management of subsidiaries, affiliates, divisions, or other operating units.
  2. The methods used to communicate responsibility and authority.
  3. The principal financial reports prepared for management planning and control purposes, such as budgets.

4. Management's supervision of the system, including the internal audit function, if any.
5. Competence of personnel.
- c. The extent of recent changes, if any, in the entity, its operations, or its control procedures.
- d. Relative significance of the various classes of transactions and related assets.
- e. Knowledge obtained in auditing the entity's financial statements and in past engagements to express an opinion on the entity's system.

**.15 Multiple locations.** For an entity with operations in several locations, the considerations involved in deciding the locations to study are similar to those involved in an audit. It may not be necessary to review and test the controls at each location. In addition to the factors listed in paragraph .14, the selection of locations to be visited should be based on factors such as (a) the similarity of business operations and control systems at different locations, (b) the degree of centralization of accounting records, (c) the effectiveness of the internal reporting system used by senior management to supervise activities at various locations, (d) the effectiveness of other supervisory activities, such as an internal audit function, and (e) the nature and amount of transactions and related assets at the various locations.

**.16 Internal audit.** Reviewing and testing the system of internal accounting control is often an important responsibility of the internal audit function. Thus, the work of the internal auditors may have an important bearing on the independent accountant's procedures. If the independent accountant will be considering or using the work of, or receiving direct assistance from, the entity's internal auditors, the accountant should follow the guidance in section 322 in considering their competence and objectivity and in evaluating their work.

**.17 Documentation.** For the accountant to be able to report on the system of internal accounting control, the accountant and management should have a common understanding both of the specific control objectives appropriate to the circumstances and of the control procedures in effect that are designed to achieve those objectives. The specific control objectives and related procedures should be appropriately documented to serve as a basis for the accountant's report. The documentation of the system may take many forms: internal control manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural writeups, or answers to questionnaires. No one particular form of documentation is necessary, and the extent of documentation will vary.

### Reviewing the Design of the System

**.18** The purpose of the review of the design of the system is to obtain sufficient information to permit the accountant to reach a conclusion about whether the entity's control procedures are suitably designed to achieve the objectives of internal accounting control.<sup>4</sup> For this purpose the accountant should obtain an understanding of

- a. The flow of transactions through the accounting system.

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<sup>4</sup> The "design" of the system refers to the plan of organization and the procedures and records that have been established.

- b. The specific control objectives that relate to points in the flow of transactions and handling of assets where errors or irregularities could occur.
- c. The specific control procedures or techniques that the entity has established to achieve the specific control objectives.

**.19 *The flow of transactions.*** The accounting system should be distinguished from the system of internal accounting control. While an accounting system may include procedures that contribute to achieving a control objective, its primary purpose is to process transactions. An accountant obtains an understanding of the accounting system to identify points in the processing of transactions and handling of assets where errors or irregularities may occur.

**.20** The accountant should obtain an understanding of the system for processing each significant class of transactions. The accountant should identify the classes of transactions processed and the related assets and, for each significant class, identify the flow of transactions from authorization through execution and recording of transactions and the accountability for the resulting assets. Transactions may be grouped in a variety of ways—for example, by cycles of business activity or by business functions.<sup>5</sup> Whatever approach is used, the accountant should identify each significant class of transactions and obtain an understanding of the flow of transactions. The accountant's procedures in obtaining such an understanding may include inspection of written documentation, inquiries of client personnel, and observation of the processing of transactions and the handling of the related assets.

**.21 *Specific control objectives.*** Paragraph .04 lists the four operative objectives of internal accounting control. Those operative objectives need to be further refined into specific control objectives for the purpose of identifying and evaluating the controls over specific classes of transactions and related assets within an entity. The accountant should determine whether management has identified the specific control objectives relating to points in the processing of transactions and the handling of assets where errors or irregularities could occur. An example of a specific control objective in a revenue cycle is that all goods shipped are billed.

**.22 *Specific control procedures.*** A system of internal accounting control should include specific control procedures designed to achieve the specific objectives of internal accounting control for each significant class of transactions and related assets. The accountant should consider the effectiveness of the specific control procedures either individually or in combination, taking into consideration the overall control environment and other applicable considerations discussed in paragraph .14. The accountant should focus on procedures in terms of their significance to the achievement of specific objectives rather than consider the specific procedures in isolation. Thus, when one or more specific control procedures are adequate to achieve a specific objective, the accountant need not consider other procedures. Alternatively, the absence or the inadequacy of one specific control procedure designed to achieve a specific objective may not be a weakness if other specific control procedures achieve the same objective.

**.23** There are two general levels of control procedures: primary and secondary. Primary control procedures are designed to achieve one or more

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<sup>5</sup> Section 320.22 explains, "Execution of transactions includes the entire cycle of steps necessary to complete the exchange of assets between parties or the transfer or use of assets within the business. . . . For example, the typical sale would involve acceptance of an order, shipment and billing of the product, and collection of the billing." [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

specific control objectives, and they generally are applied at points where errors or irregularities could occur in the processing of transactions and the handling of assets. Primary control procedures may be applied to transactions and assets individually or at various levels of summarization. Examples of primary control procedures are monthly reconciliations of bank accounts and systematic matching of receiving documents with vendor invoices, when these functions are performed by persons who have no incompatible duties.

.24 Secondary control procedures include any administrative controls or other management functions that achieve, or contribute to the achievement of, specific control objectives and thus are comprehended in the definition of internal accounting control (section 320.11). Such procedures are designed primarily to achieve broader management objectives, and they are not a part of the processing of transactions and the handling of assets. Examples of secondary controls include the systematic comparison of recorded transactions and account balances with expected results based on such sources of information as budgets, standard costs, engineering estimates, prior experience, and management's personal knowledge of operations. The effectiveness of such comparisons for the purpose of deterring or detecting errors and irregularities depends on the reliability of the sources of information used and on the thoroughness of the investigation of variations from the expected results. Accordingly, careful consideration and judgment is required in evaluating the effectiveness of secondary controls. [Reference changed by the issuance of Statement on Auditing Standards No. 48.]

#### Testing Compliance With Prescribed Procedures

.25 The purpose of tests of compliance is to provide a basis for the accountant to reach a conclusion about whether the specific control procedures necessary for the achievement of specific control objectives are being applied as prescribed as of the specified date of his study and evaluation.

.26 The nature and extent of the accountant's tests of compliance with prescribed procedures in an engagement to express an opinion on the system of internal accounting control involve essentially the same considerations as tests of compliance made as part of an audit. The nature, timing, and extent of the auditor's tests of compliance with those controls on which he relies in an audit are discussed in section 320.64—.72. [Reference changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.27 In an engagement to express an opinion on a system as of a specified date, the period of time necessary for testing compliance varies with the nature of the controls being tested. Some control procedures may function continuously (for example, control procedures over sales), but other control procedures may operate only at certain times (for example, control procedures relating to the preparation of interim financial statements). In addition, some control procedures that function continuously may be used frequently (for example, control procedures over customer receivables), while others may be used less frequently (for example, control procedures over advances to employees). The accountant should test compliance with control procedures over a period that is adequate for him to determine whether the specific control procedures are being applied as prescribed as of the date specified in his report.

.28 Management may change its system of internal accounting control to correct weaknesses in the existing system or to make it more efficient. The accountant does not need to consider the superseded controls. If the accountant determines that the new control procedures achieve the related specific

objectives of internal accounting control and that the procedures have been in effect for a sufficient time to permit the accountant to test compliance with them, the accountant's review and testing of these procedures would not require any additional considerations.

#### **Evaluating the Results of the Review of the Design of the System and Tests of Compliance**

**.29** In evaluating a system of internal accounting control for the purpose of expressing an opinion on the system as a whole, the accountant should consider the results of his review of the design of the system and of his tests of compliance. For this purpose, the accountant should identify weaknesses in the system and evaluate whether they are material, either individually or in combination.

**.30** A weakness in internal accounting control is a condition in which the specific control procedures, or the degree of compliance with them, are not sufficient to achieve a specific control objective—that is, errors or irregularities may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. A weakness is material if the condition results in more than a relatively low risk of such errors or irregularities in amounts that would be material in relation to financial statements (see paragraph .06).

**.31** In evaluating an individual weakness, the accountant should recognize that

- a. The amounts of errors or irregularities that may occur and remain undetected range from zero to the gross amount of assets or transactions exposed to the weakness.
- b. The risk or probability of errors or irregularities is likely to be different for the different possible amounts within that range. For example, the risk of errors or irregularities in amounts equal to the gross exposure may be very low, but the risk of smaller amounts may be progressively greater.

**.32** In evaluating the combined effect of individually immaterial weaknesses, the accountant should consider

- a. The range or distribution of the amounts of errors or irregularities that may result during the same accounting period from two or more individual weaknesses.
- b. The joint risk or probability that such a combination of errors or irregularities would be material.

**.33** The evaluation of identified weaknesses necessarily is a very subjective process that depends on such factors as the nature of the accounting process and of any assets exposed to the weaknesses, the overall control environment, and the experience and judgment of those making the estimates. The accountant should consider, to the extent that it is applicable in the current conditions, any relevant historical data that are available or can reasonably be developed.

.34 Historical data provide a more reasonable basis for estimating the risk of errors than they do for estimating the risk of irregularities. Errors are unintentional, and their underlying causes tend to result in a more recurring or predictable level of occurrence. Irregularities are intentional, and their underlying causes ordinarily involve a lack of integrity and a motivation for personal gain, which are less predictable from historical experience. Thus, the accountant should presume a high risk of irregularities if inadequate segregation of duties places an individual in a position to perpetrate and to conceal irregularities in the normal course of that person's duties.

### **Management's Written Representations**

.35 The accountant should ordinarily obtain management's written representations

- a. Acknowledging management's responsibility for establishing and maintaining the system of internal accounting control.
- b. Stating that management has disclosed to the accountant all material weaknesses in the system of which they are aware, including those for which management believes the cost of corrective action may exceed the benefits.
- c. Describing any irregularities involving management or employees who have significant roles in the system of internal accounting control.
- d. Stating whether there were any changes subsequent to the date being reported on that would significantly affect the system of internal accounting control, including any corrective action taken by management with regard to material weaknesses.

### **The Accountant's Working Papers**

.36 The extent to which the accountant documents the engagement to express an opinion on a system of internal accounting control is a matter of professional judgment. The judgment is similar to that made in connection with an audit. Documents prepared by the entity to describe its system of internal accounting control may be used by the accountant in his working papers.

### **The Form of the Accountant's Report**

.37 An independent accountant may express an opinion on a system of internal accounting control of any entity for which financial statements in conformity with generally accepted accounting principles, or any other criteria applicable to such statements, can be prepared.

.38 The accountant's report expressing an opinion on an entity's system of internal accounting control should contain

- a. A description of the scope of the engagement.
- b. The date to which the opinion relates.
- c. A statement that the establishment and maintenance of the system is the responsibility of management.
- d. A brief explanation of the broad objectives and inherent limitations of internal accounting control.
- e. The accountant's opinion on whether the system taken as a whole was sufficient to meet the broad objectives of internal accounting



control insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to financial statements.

The report should be dated as of the date of completion of field work and may be addressed to the entity whose system is being studied or to its board of directors or stockholders.

### **Standard Form of Report**

**.39** The following language should be used to express an unqualified opinion on an entity's system of internal accounting control:

We have made a study and evaluation of the system of internal accounting control of XYZ Company and subsidiaries in effect at (date). Our study and evaluation was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

The management of XYZ Company is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with the procedures may deteriorate.

In our opinion, the system of internal accounting control of XYZ Company and subsidiaries in effect at (date), taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the consolidated financial statements.

### **Reporting Material Weaknesses**

**.40** If the study and evaluation discloses conditions that, individually or in combination, result in one or more material weaknesses, the opinion paragraph of the accountant's report (paragraph .39) should be modified as follows:

Our study and evaluation disclosed the following conditions in the system of internal accounting control of XYZ Company and subsidiaries in effect at (date), which, in our opinion, result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the consolidated financial statements may occur and not be detected within a timely period.

The report should describe the material weaknesses, state whether they result from the absence of control procedures or the degree of compliance with them, and describe the general nature of potential errors or irregularities that may occur as a result of the weaknesses. The accountant may want to report to management other weaknesses even though they are not considered to be material (see paragraphs .51 through .53).

**.41** If a document that contains an accountant's opinion identifying a material weakness also includes a statement by management asserting that

the cost of correcting the weakness would exceed the benefits of reducing the risk of errors or irregularities, the accountant should not express any opinion as to management's statement.<sup>6</sup> However, the accountant is not precluded from disclaiming an opinion on any such statement.

**.42** If management has implemented control procedures to correct the weakness, the accountant should not refer to this corrective action unless he has satisfied himself that the procedures are suitably designed and are being applied as prescribed.

**.43** If the opinion on the internal accounting control system is issued in conjunction with an examination of the entity's financial statements, the following sentence should be included in the paragraph that describes the material weakness:

These conditions were considered in determining the nature, timing, and extent of audit tests to be applied in our examination of the 19XX financial statements, and this report does not affect our report on these financial statements dated (date of report).

### **Scope Limitations**

**.44** An unqualified opinion on an entity's system of internal accounting control can be expressed only if the accountant has been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of his engagement, whether imposed by the client or by the circumstances, may require the accountant to qualify or disclaim an opinion. The accountant's decision to qualify or disclaim an opinion because of a scope limitation depends on the accountant's assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the system of internal accounting control. When restrictions that significantly limit the scope of the study and evaluation are imposed by the client, the accountant generally should disclaim an opinion on the system of internal accounting control.

### **Opinion Based in Part on the Report of Another Accountant**

**.45** When an accountant decides to make reference to the report of another accountant as a basis, in part, for his opinion, he should disclose this fact in stating the scope of his examination and should refer to the report of the other accountant in expressing his opinion. In these circumstances, the considerations are similar to those that arise when the independent auditor reporting on financial statements uses the work and reports of other independent auditors (see section 543).

### **Subsequent Information**

**.46** The accountant has no responsibility to keep informed of events subsequent to the date of the report; however, the accountant may later become aware of conditions that existed at the date of the report that might have affected his opinion had he been aware of them. The accountant's consideration of such subsequent information is similar to an auditor's consideration of comparable information discovered subsequent to the date of his report on an audit of financial statements (see section 561).

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<sup>6</sup> This is not intended to preclude an accountant from advising his client with respect to the practicability of specific control procedures that may be under consideration. However, as is the case in other matters involving advice by an accountant, it is the responsibility of management to make the decisions concerning costs to be incurred and related benefits.

## **Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit [7] [8] [9]**

[.47—.53] [Superseded April 1988, by Statement on Auditing Standards No. 60.] (See section 325.)

## **Reports Based on Criteria Established by Regulatory Agencies**

**.54** Some governmental or other agencies that exercise regulatory, supervisory, or other public administrative functions may require reports on internal accounting controls of organizations subject to their regulations. A report on internal accounting control in the form illustrated in paragraphs .39 or .49 may be acceptable to such an agency; however, an agency may set forth specific criteria for the evaluation of the adequacy of internal accounting control procedures for their purposes and may require a report based on those criteria.

**.55** Criteria established by an agency may be set forth in audit guides, questionnaires, or other publications. The criteria may encompass specified aspects of internal accounting control and may also encompass specified aspects of administrative control or of compliance with grants, regulations, or statutes. For the accountant to be able to issue the report described in paragraph .56, the criteria should be in reasonable detail and in terms susceptible to objective application.<sup>10</sup>

**.56** The accountant's report should (a) clearly identify the matters covered by his study,<sup>11</sup> (b) indicate whether the study included tests of compliance with the procedures covered by his study, (c) describe the objectives and limitations of internal accounting control and of accountants' evaluations of it, (d) state the accountant's conclusions, based on the agency's criteria, concerning the adequacy of the procedures studied, with an exception regarding any material weaknesses, and (e) state that it is intended for use in connection with the grant or other purpose to which the report refers and that it should not be used for any other purpose.<sup>12</sup> If the agency requires the accountant to report on all conditions (whether material or not) that are not in conformity with the agency's criteria, the accountant should do so. If the agency does not require the accountant to report on conditions that are not material, he may do so, and he may also include recommendations for corrective action or describe corrective actions taken by the organization (see paragraph .42).

**.57** For the purpose of these reports, a material weakness includes either (a) a condition that results in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the applicable grant or program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions or (b) a condition in which the lack of conformity with the agency's criteria is material

[7] [Superseded April 1988, by Statement on Auditing Standards No. 60.] (See section 325).

[8] [Superseded April 1988, by Statement on Auditing Standards No. 60.] (See section 325).

[9] [Superseded April 1988, by Statement on Auditing Standards No. 60.] (See section 325).

<sup>10</sup> Also, an agency may require a report on the design of an internal accounting control system before the organization has started operations.

<sup>11</sup> This can be accomplished by reference to the publication in which the established criteria are set forth.

<sup>12</sup> This form of reporting is appropriate even though the regulatory agency may make the accountant's report a matter of public record.

in accordance with any guidelines for determining materiality that are included in such criteria.

**.58** When the accountant issues this form of report, he does not assume any responsibility for the comprehensiveness of the criteria established by the agency; however, he should report any relevant condition that comes to his attention in the course of his study that he believes to be a material weakness, even though it is not covered by such criteria.

**.59** The following report is illustrative of the type of report considered appropriate for a study based on pre-established criteria:

(Scope paragraph)

We understand that (recipient) has been awarded a grant of (amount) from (agency) for the period from (date) through (date) for use in accordance with the (title or description of program). We have made a study of those internal accounting control and administrative control procedures of (recipient) that we considered relevant to the criteria established by (agency), as set forth in (section) of its audit guide, issued (date). Our study included tests of compliance with such procedures during the period from (date) through (date). Our study did not constitute an audit of any financial statements prepared by (recipient).

(Explanatory paragraphs, see paragraph .39) \*

(Concluding paragraphs)

We understand that procedures in conformity with the criteria referred to in the first paragraph of this report are considered by the (agency) to be adequate for its purpose in accordance with (name of act) and related regulations, and that procedures not in conformity with those criteria indicate some inadequacy for such purposes. Based on this understanding and on our study, we believe (recipient's) procedures were adequate for the agency's purposes, except for the conditions described (reference to appropriate section of report), which we believe are material weaknesses in relation to the grant to which this report refers. In addition to these weaknesses, other conditions that we believe are not in conformity with the criteria referred to above are described (reference to appropriate section of report).

This report is intended for the information of (recipient) and (agency) and should not be used for any other purpose.

## Other Special Purpose Reports

**.60** An accountant may be engaged to issue a special report for the restricted use of management, another independent accountant, or other specified third parties, on all or a part of an entity's system of internal accounting control or proposed system of internal accounting control. For example, such reports may relate to (a) a study of system design without tests of compliance or (b) the results of applying agreed-upon procedures that are not sufficient for the purpose of expressing an opinion on the system taken as a whole.<sup>[†]</sup>

**.61** The form of report in these circumstances is flexible, but it should (a) describe the scope and nature of the accountant's procedures, (b) disclaim an opinion on whether the system, taken as a whole, meets the objectives of internal accounting control, (c) state the accountant's findings, and (d) indicate that the report is intended solely for management or specified third parties.\*\*

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\* EDITOR'S NOTE: See section 9642.02.

[†] [Footnote deleted, June 1992, by the issuance of SAS No. 70.]

\*\* See footnotes 7 and 12. [Footnote added by Auditing Standards Board.]

## Appendix

.62 This section amends SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, paragraphs .01, .08 and .09 to read as follows:

1. This section requires the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that come to his attention during an examination of financial statements made in accordance with generally accepted auditing standards.\* A material weakness in internal accounting control is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. See section 642.31—.34 for factors to be considered in estimating the amounts of errors and irregularities that might result from identified weaknesses in internal accounting control.

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8. The form of communication is optional. When the auditor communicates in writing, the suggested form of report is included in section 642.49—.50. Because it is not practicable to communicate the varying extent of such studies in different engagements, these reports should be prepared for the restricted use of management, the board of directors, or its audit committee.†

9. If the auditor becomes aware of material weaknesses for which management believes corrective action is not practicable, he may refer to the circumstances and summarize the weaknesses; a detailed communication of the circumstances and related weaknesses is not required. When a written report is issued, the related sentence would state: "However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period, but management believes corrective action is not practicable in the circumstances." The auditor would then summarize the weaknesses and describe the circumstances (for example, inadequate control over cash transactions because of inadequate segregation of duties due to limited personnel).

This section amends section 320.77 to read as follows:

The auditor's evaluation of accounting control with reference to each significant class of transactions and related assets should be a conclusion about whether the prescribed procedures and compliance therewith are satis-

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\* See also section 722, *Interim Financial Information*, paragraph .11, which states: "If the internal control structure appears to contain deficiencies so significant that it is impracticable for the accountant to effectively apply his or her knowledge of accounting and financial reporting practices to the interim financial information, the accountant should consider whether this precludes completion of such a review." [Reference changed by issuance of SAS No. 71.]

† However, when the study and evaluation made as a part of the audit is sufficient for expressing an opinion on the system, see section 642.37—.46.

factory for his purpose. The procedures and compliance should be considered satisfactory if the auditor's review and tests disclose no condition he believes to be a material weakness for his purpose. In this context, a material weakness is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. These criteria may be broader than those that may be appropriate for evaluating weaknesses in accounting control for management or other purposes. If the auditor is aware of a material weakness in internal accounting control, whether or not he is specifically engaged by the client to review and report on the system of internal accounting control, a communication as described in section 323, *Required Communication of Material Weaknesses in Internal Accounting Control*, is required.

[Reference number 320.72, formerly 320.68, changed by the issuance of Statement on Auditing Standards No. 43. Subsequently, reference number 320.77, formerly 320.72, changed by the issuance of Statement on Auditing Standards No. 48.]

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[The next page is 1221.]

## AU Section 9642

# Reporting on Internal Accounting Control: Auditing Interpretations of Section 642

The concepts of section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit* have a considerable effect on considerations auditors should make in reporting on the internal accounting control of an entity. The Auditing Standards Board is developing guidance to amend section 642, *Reporting on Internal Accounting Control*, that will, among other things, relate the concepts of the auditing interpretation in section 9642 with those of section 319. An exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, which would supersede section 642, has been issued.

### 1. Pre-Award Surveys

**.01 Question**—If an independent auditor is engaged to perform a pre-award survey in connection with a government grant program, how should he report on the design of the system of internal accounting control, including incorporation of comments on the agency's criteria?

**.02 Interpretation**—The report illustrated in section 642.59 should be modified in the following way to recognize the circumstances of a pre-award survey:

We understand that (applicant) has applied for a grant of \$...... from (agency) for the period from ..... through ..... for use in accordance with the (title or description of program). We have made a study of the design of those internal accounting control and administrative control procedures of (applicant) that we considered relevant to the criteria established by (agency) as set forth in section ..... of its Audit Guide issued (date). Since our study related to procedures (applicant) proposes to follow if the grant is awarded, it did not include tests of compliance with such procedures. Our study did not constitute an audit of any financial statements prepared by (applicant).

The management of (applicant) is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. We understand that the objective of those administrative control procedures

comprehended in the (agency's) criteria is to provide similar assurance as to compliance with its related requirements.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

We understand that procedures in conformity with the criteria referred to in the first paragraph of this report are considered by the (agency) to be adequate for its purposes in accordance with the (name of act) and related regulations, and that procedures not in conformity therewith indicate some inadequacy for such purposes. Based on this understanding and on our study, we believe the (applicant's) procedures would be adequate for the agency's purposes, assuming satisfactory compliance, except for the conditions described (reference to appropriate section of report) which we believe would be material weaknesses in relation to the grant to which this report refers.\* In addition to these weaknesses, other conditions that we believe would not be in conformity with the criteria referred to above are described (reference to appropriate section of report).

This report is intended for the information of (applicant) and (agency) and should not be used for any other purpose.

.03 Since neither a pre-award nor post-award survey constitutes an audit of financial statements, the survey report should include a statement to that effect.

[Issue Date: January, 1973; modified: August, 1980.]

## 2. Award Survey Made in Conjunction With an Audit

.04 *Question*—How should the report differ when the study is made in conjunction with an audit engagement?

.05 *Interpretation*—The last sentence of the scope paragraph of the illustrative report in section 642.59 should be replaced by the following:

..... We have examined the financial statements of (recipient) for the year ended ..... and have issued our report thereon dated .....

Also, the following sentence should be included in the paragraph that describes material weaknesses, if any:

These conditions were considered in determining the nature, timing, and extent of audit tests to be applied in our examination of the financial statements for the year ended ..... and this report does not affect our report on these financial statements dated .....

[Issue Date: January, 1973; modified: August, 1980.]

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\* If the auditor is aware of a material weakness in internal accounting control, whether or not he is specifically engaged by the client to review and report on the system of internal accounting control, a communication as described in section 325, *Internal Control Structure Related Matters Noted in an Audit*, is required.



### 3. Reporting on Matters Not Covered by Government-Established Criteria

**.06 Question**—The reports illustrated for pre-award and other surveys refer to the criteria set forth in an agency's audit guide. May the auditor provide negative assurance on other matters?

**.07 Interpretation**—Since it is not possible to anticipate all matters which may be of interest to the governmental agency, the auditor should not make a general statement in his report that nothing else has come to his attention that would be of interest to the agency.

[Issue Date: January, 1973; modified: August, 1980.]

### 4. Limited Scope

**.08 Question**—At times the terms of an engagement do not permit the examination of a delegate agency's (agencies') financial statements, internal accounting controls and compliance with provisions of an act and related regulations or instructions. How should the auditor modify his report on internal accounting control if he is not in a position to report on the delegate agency's (agencies') operations?

**.09 Interpretation**—If the operations of the delegate agency (agencies) are sufficiently material in the combined operations of the principal grant recipient and the delegate agency (agencies) and the latter is either unaudited or the work of other auditors is not acceptable to the primary auditor, an unqualified opinion cannot be expressed on the financial statements covering the combined operations of the principal grant recipient and the delegate agency (agencies). The report on internal accounting control, however, need not be an overall disclaimer if it clearly indicates in its scope and concluding paragraphs that it pertains only to the organization covered by the auditor's engagement. This distinction is appropriate if conditions with respect to internal accounting control in several organizations cannot be combined in a meaningful way and therefore there is no overall or combined system to which a disclaimer could relate.

[Issue Date: January, 1973; modified: August, 1980.]

### 5. Compliance With the Foreign Corrupt Practices Act of 1977

**.10 Question**—Certain provisions of the *Foreign Corrupt Practices Act of 1977*, generally referred to as the accounting provisions, amend the Securities Exchange Act of 1934 and provide in part that every issuer which has a class of securities registered under section 12 and every issuer which is required to file reports under section 15(d) shall devise and maintain a system of internal accounting control sufficient to provide reasonable assurance that—

- transactions are executed in accordance with management's general or specific authorization;
- transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (2) to maintain accountability for assets;
- access to assets is permitted only in accordance with management's general or specific authorization; and

● the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

.11 Section 623.19—.21 provides guidance with respect to reports on compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements. May the auditor issue a report that provides assurance on an entity's compliance with this provision of the Act?

.12 *Interpretation*—No. The auditor should not issue a report that provides assurance on compliance with the internal accounting control provision of the Act. Section 623.19—.21 was not intended to cover reports on internal accounting control. Sections 325 and 642 apply to reports on internal accounting control. Although section 642 permits an auditor to express an opinion on an entity's system of internal accounting control, as explained in section 642.12: "Whether a company is in compliance with those provisions of the FCPA is a legal determination. An independent accountant's opinion does not indicate whether the company is in compliance with those provisions. . . ."

.13 Nevertheless, communications by the auditor as specified in sections 325 and 642 may be useful to an entity's management and its legal counsel in evaluating compliance with the internal accounting control provision of the Act. However, since the standards for determining a violation of the Act may differ from those applied by an auditor in determining material weaknesses, the auditor may wish to include a statement to that effect in any communication concerning internal accounting control.

[Issue Date: October, 1978; modified: August, 1980.]

## 6. Reports on Internal Accounting Control of Trust Departments of Banks

.14 *Question*—Independent accountants may be engaged to report on a system of internal accounting control maintained by the department of a bank or similar entity which is responsible for safeguarding assets held for others in trust or in custody accounts ("trust departments"). Trust departments may also execute investment transactions and be responsible for various administrative functions. While the trust department may have responsibility for the custody of trust assets, they are not assets of the bank and, therefore are not included in the bank's financial statements. Is it permissible for an accountant to express an opinion on the system of internal accounting control maintained by a trust department?

.15 *Interpretation*—Yes. Section 642.37 states: "An independent accountant may express an opinion on a system of internal accounting control of an entity for which financial statements in conformity with generally accepted accounting principles, or any other criteria applicable to such statements, *can be prepared*." (Emphasis added.) This does not mean that financial statements of the entity necessarily have to be prepared. When the "entity" is a segment, such as a subsidiary, a branch, or a department, the primary concern in applying the criterion of section 642.37 is that the assets and activities of the segment can be clearly distinguished, physically and operationally and for financial reporting purposes, from the other assets and activities of the organization. Accordingly, if the activities of the trust department are clearly distinguishable from other activities of the bank, and the scope of his work is not limited, an accountant can express an opinion on the system of internal accounting control maintained by the trust department.

.16 Ordinarily, the form of opinion on a system of internal accounting control is that the system taken as a whole was sufficient to meet the broad objectives of internal accounting control "insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the [entity's] financial statements." However, in engagements of this nature, the basis for assessing the materiality of potential errors or irregularities is the bank's financial statements since the responsibility for errors or irregularities occurring in the trust department would generally be borne by the bank.

.17 Also, the standard form of report should be revised to recognize the special objectives that exist when an accountant is expressing an opinion on a system of internal accounting control maintained by a trust department. The following type of report is considered appropriate in such circumstances. The description of the responsibilities of the trust department should be modified as appropriate based on the circumstances of the individual engagement.

We have made a study and evaluation of the system of internal accounting control of the Trust Department of Blank Bank and Trust Company in effect at [that existed during the year ended] (date), which department has responsibility for personal, custodial, and corporate trust accounts. Our study and evaluation was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

The management of Blank Bank and Trust Company is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets for which the Trust Department has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed and recorded in accordance with management's authorization and in conformity with the governing instruments.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system of future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

In our opinion, the system of internal accounting control of the Trust Department of Blank Bank and Trust Company in effect at [that existed during the year ended] (date), taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the financial statements of Blank Bank and Trust Company.

[Issue Date: January, 1981.]

**[7.] Report Required by U.S. General Accounting Office<sup>[1-7]</sup>**

[.18—.25] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

**[8.] Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit<sup>[8-10]</sup>**

[.26—.32] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

**[9.] Reporting on Internal Accounting Control Based Solely on an Audit When a Minimum Study and Evaluation Is Made**

[.33—.34] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

**[10.] Report Required by U.S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase<sup>[11-15]</sup>**

[.35—.36] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

**[11.] Restricted Purpose Report Required by Law to Be Made Available to the Public<sup>[16]</sup>**

[.37—.38] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

**12. Reporting on Internal Accounting Control "Compliance With the Currency and Foreign Transactions Reporting Act"**

**.39 Question**—Financial institutions are required by the Federal Home Loan Bank Board (FHLBB) to engage an independent auditor to study and test an institution's procedures for compliance with FHLBB T Memorandum 53-7 and issue a special purpose report in accordance with section 642, *Reporting on Internal Accounting Control*, paragraphs .60 and .61, in conjunction with the annual audit of the institution's financial statements. What are some procedures that the auditor might agree to perform to fulfill this requirement, and what is the proper form of the auditor's report?

**.40 Interpretation**—Examples of procedures that the auditor might agree to perform include, but are not limited to, the following. Note: An institution's location, types of customers, or other factors might require performing more detailed procedures.

**I. Review operating procedures and compliance guidelines****A. Obtain and read relevant sections of the Currency and Foreign Transactions Reporting Act, 31 U.S.C. sections 5313 (Reports**

<sup>[1-7]</sup> [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

<sup>[8-10]</sup> [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

<sup>[11-15]</sup> [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

<sup>[16]</sup> [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

on exporting and importing monetary instruments), and 5318 (Compliance and exemptions), and related Treasury regulations, including any revisions or modifications; FHLBB Bulletin PA-7a-3; and FHLBB T Memorandums 53-7, 53-8, and 53-9. Understand requirements for:

1. Currency Transaction Report (Form 4789).
  2. Reports of International Transportation of Currency or Monetary Instruments (Form 4790).
  3. Maintenance of exemptions.
- B. Determine whether the institution has established, preferably in writing, operating procedures and compliance guidelines which cover:
1. Filing of Form 4789.
  2. Filing of Form 4790.
  3. Maintenance of an exemption list.
- C. Determine whether the institution's operation procedures and compliance guidelines include the following features discussed in T Memorandum 53-7:
1. Requiring centralized control and review of compliance with the Currency and Foreign Transactions Reporting Act.
  2. Encouraging the reporting of large deposits consisting of numerous and/or out-of-area items of less than \$10,000.
  3. Encouraging the reporting of any unusual or suspicious purchase of cashier's checks, official checks, money orders, etc. by non-customers.
  4. Verifying the identity of non-customers purchasing such items from identity cards with pictures.
- D. Determine whether the institution has established training programs for applicable employees regarding requirements of the Act and T Memorandum 53-7; completion of appropriate forms; verification of exemptions.
- E. Determine whether the institution has established specific controls for identifying reportable transactions including controls established, if any, for accumulating and reporting transactions by or for any person which in any one day total more than \$10,000.\*
- II. Compliance testing
- A. Select a sample of employees/periods that receive/disburse currency during the period.
1. Determine whether employees have received training.
  2. Obtain cash proof sheets and other summary records including tapes or other detailed information for the test period.

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\* The instructions for completing Form 4789 indicate that multiple transactions by or for any person which in any one day total more than \$10,000 should be treated as a single transaction, if the financial institution is aware of them.

3. Identify reportable transactions. (The definition of "reportable transaction" can vary from institution to institution. That is, an institution could require any transaction over \$10,000 to be reported to the Treasury Department, as specified by the Currency and Foreign Transactions Reporting Act. Alternatively, an institution could establish a policy which requires any transaction of some specified amount of less than \$10,000 to be reported to a central reporting area for accumulation and review and subsequent reporting to the Treasury Department.)
  4. For those identified, reportable transactions, ascertain whether they have been: (1) reported on the appropriate form or included on the exemption list, if not recorded; or (2) reported to a central reporting area for accumulation and review and subsequent reporting to the Treasury Department, if applicable.
- B. Obtain the file of reports submitted during the period.
1. On a test basis, determine whether the forms are
    - completed properly;
    - submitted to the appropriate authority on a timely basis.
  2. Determine whether the institution has a procedure to retain copies of the reports filed for the past five years.
- C. Obtain the institution's list of exempt customers.
1. On a test basis
    - Determine whether all required information has been obtained from exempt customers.
    - Determine that exemptions granted are approved and conform to the institution's policy.

.41 The following illustrates the type of auditor's report that would be issued under the FHLBB requirement:

### **SAMPLE REPORT**

The Board of Directors

ABC Institution

At your request, we have performed the procedures described below with respect to the internal accounting control and administrative control procedures of ABC Institution for transactions subject to the reporting and recordkeeping provisions of the Currency and Foreign Transactions Reporting Act. Our procedures included tests of compliance with such internal accounting control and administrative control procedures during the period from ..... through ..... Our procedures were performed solely to assist you in determining compliance with FHLBB T Memorandum 53-7. This report is intended for the use of ABC Institution's management and the FHLBB and should not be used for any other purpose. The procedures

we performed, and the results of these procedures, are summarized as follows:

(Description of procedures performed and findings)

Because the above procedures do not constitute a study and evaluation of the system of internal accounting control of ABC Institution in effect at ....., we do not express an opinion on whether the system, as a whole, meets the objectives of internal accounting control. Had we performed additional procedures, or had we made a study and evaluation of the system of internal accounting control, other matters might have come to our attention that would have been reported to you. This report relates only to the procedures specified above and does not extend to any financial statements of ABC Institution.

[Issue Date: January, 1987.]

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## AU Section 700

## SPECIAL TOPICS

... filings under federal securities statutes ... interim financial information ...

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## AU Section 711

### ***Filings Under Federal Securities Statutes***

Source: SAS No. 37.

See section 9711 for interpretations of this section.

Issue date, unless otherwise indicated: April, 1981.

.01 As in the case of financial statements used for other purposes, management has the responsibility for the financial representations contained in documents filed under the federal securities statutes. In this connection the Securities and Exchange Commission has said:

The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon the accounting.<sup>1</sup>

.02 When an independent accountant's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes, the accountant's responsibility, generally, is in substance no different from that involved in other types of reporting. However, the nature and extent of this responsibility are specified in some detail in these statutes and in the related rules and regulations. For example, section 11(a) of the Securities Act of 1933, as amended, imposes responsibility for false or misleading statements in an effective registration statement, or for omissions that render statements made in such a document misleading, on

every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him.

.03 Section 11 also makes specific mention of the independent accountant's responsibility as an expert when his report is included in a registration statement filed under that act.<sup>2</sup> Section 11(b) states, in part, that no person

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NOTE: This section supersedes Statement on Auditing Standards No. 1, section 710, *Filings Under Federal Securities Statutes*. The changes provide guidance for the accountant whose report based on a review of interim financial information is presented, or incorporated by reference, in a filing under the Securities Act of 1933.

<sup>1</sup> 4 S. E. C. 721 (1939).

<sup>2</sup> Under rules of the Securities and Exchange Commission, a report based on a review of interim financial information is not a report by the accountant under section 11 (see paragraph .06).

shall be liable as provided therein if that person sustains the burden of proof that

as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert. . . .

Section 11 further provides that, in determining what constitutes reasonable investigation and reasonable ground to believe, "the standard of reasonableness shall be that required of a prudent man in the management of his own property."

**.04** This discussion of the independent accountant's responsibilities in connection with filings under the federal securities statutes is not intended to offer legal interpretations and is based on an understanding of the meaning of the statutes as they relate to accounting principles and auditing standards and procedures. The discussion is subject to any judicial interpretations that may be issued.

**.05** Because a registration statement under the Securities Act of 1933 speaks as of its effective date, the independent accountant whose report is included in such a registration statement has a statutory responsibility that is determined in the light of the circumstances on that date. This aspect of responsibility is peculiar to reports used for this purpose (see paragraphs .10 through .12).

**.06** Under rules of the Securities and Exchange Commission, an independent accountant's report based on a review of interim financial information is not a report by the accountant within the meaning of section 11. Thus, the accountant does not have a similar statutory responsibility for such reports as of the effective date of the registration statement (see paragraph .13).

**.07** The other federal securities statutes, while not containing so detailed an exposition, do impose responsibility, under certain conditions, on persons making false or misleading statements with respect to any material fact in applications, reports, or other documents filed under the statute.

**.08** In filings under the Securities Act of 1933, a statement frequently is made in the prospectus (sometimes included in a section of the prospectus

called the *experts section*) that certain information is included in the registration statement in reliance upon the report of certain named experts. The independent accountant should read the relevant section of the prospectus to make sure that his name is not being used in a way that indicates that his responsibility is greater than he intends. The experts section should be so worded that there is no implication that the financial statements have been prepared by the independent accountant or that they are not the direct representations of management.

.09 The Securities and Exchange Commission requires that, when an independent accountant's report based on a review of interim financial information is presented or incorporated by reference in a registration statement, a prospectus that includes a statement about the independent accountant's involvement should clarify that his review report is not a "report" or "part" of the registration statement within the meaning of sections 7 and 11 of the Securities Act of 1933. In this respect, wording such as the following in a prospectus would ordinarily be considered a satisfactory description for the accountant's purposes of the status of his review report that was included in a Form 10-Q filing that was later incorporated by reference in a registration statement.<sup>3</sup>

#### Independent Public Accountants

The consolidated balance sheets as of December 31, 19X2 and 19X1, and the consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X2, incorporated by reference in this prospectus, have been included herein in reliance on the report of \_\_\_\_\_ independent public accountants, given on the authority of that firm as experts in auditing and accounting.

With respect to the unaudited interim financial information for the periods ended March 31, 19X3 and 19X2, incorporated by reference in this prospectus, the independent public accountants have reported that they have applied limited procedures in accordance with professional standards for a review of such information. However, their separate report included in the company's quarterly report on Form 10-Q for the quarter ended March 31, 19X3, and incorporated by reference herein, states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. The accountants are not subject to the liability provisions of section 11 of the Securities Act of 1933 for their report on the unaudited interim financial information because that report is not a "report" or a "part" of the registration statement prepared or certified by the accountants within the meaning of sections 7 and 11 of the act.

The independent accountant should also read other sections of the prospectus to make sure that his name is not being used in a way that indicates that his responsibility is greater than he intends.

### Subsequent Events Procedures in 1933 Act Filings

.10 To sustain the burden of proof that he has made a "reasonable investigation" (see paragraph .03), as required under the Securities Act of 1933, an auditor should extend his procedures with respect to subsequent events from the date of his audit report up to the effective date or as close

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<sup>3</sup> A similar description of the status of the accountant's report would also ordinarily be satisfactory for the accountant's purposes when the accountant's review report is presented in the registration statement rather than incorporated by reference. In that case, the description in the prospectus would specifically refer to that report in the registration statement.

thereto as is reasonable and practicable in the circumstances. In this connection, he should arrange with his client to be kept advised of the progress of the registration proceedings so that his review of subsequent events can be completed by the effective date. The likelihood that the auditor will discover subsequent events necessarily decreases following the completion of field work, and, as a practical matter, after that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees. In addition to performing the procedures outlined in section 560.12, at or near the effective date, the auditor generally should

- a. Read the entire prospectus and other pertinent portions of the registration statement.
- b. Inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters (limited where appropriate to major locations) about whether any events have occurred, other than those reflected or disclosed in the registration statement, that, in the officers' or other executives' opinion, have a material effect on the audited financial statements included therein or that should be disclosed in order to keep those statements from being misleading.

.11 A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their audits of the financial statements for different periods. An auditor who has audited the financial statements for prior periods but has not audited the financial statements for the most recent audited period included in the registration statement has a responsibility relating to events subsequent to the date of the prior-period financial statements, and extending to the effective date, that bear materially on the prior-period financial statements on which he reported. Generally, he should

- a. Read pertinent portions of the prospectus and of the registration statement.
- b. Obtain a letter of representation from the successor independent auditor regarding whether his audit (including his procedures with respect to subsequent events) revealed any matters that, in his opinion, might have a material effect on the financial statements reported on by the predecessor auditor or would require disclosure in the notes thereto.

The auditor should make inquiries and perform other procedures that he considers necessary to satisfy himself regarding the appropriateness of any adjustment or disclosure affecting the prior-period financial statements covered by his report (see section 508).

## **Response to Subsequent Events and Subsequently Discovered Facts**

.12 If, subsequent to the date of his report on audited financial statements, the auditor (including a predecessor auditor) (a) discovers, in performing the procedures described in paragraphs .10 and .11 above, subsequent events that require adjustment or disclosure in the financial statements or (b) becomes aware that facts may have existed at the date of his report that might have affected his report had he then been aware of those facts, he should follow the guidance in sections 560 and 561. If the financial statements are appropriately adjusted or the required additional disclosure is made, the auditor should follow the guidance in sections 530.05 and 530.07—.08, with

respect to dating his report. If the client refuses to make appropriate adjustment or disclosure in the financial statements for a subsequent event or subsequently discovered facts, the auditor should follow the procedures in section 561.08—.09. In such circumstances, the auditor should also consider, probably with the advice of his legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement.

.13 If an accountant concludes on the basis of facts known to him that unaudited financial statements or unaudited interim financial information presented or incorporated by reference in a registration statement are not in conformity with generally accepted accounting principles, he should insist on appropriate revision. Failing that,

- a. If the accountant has reported on a review of such interim financial information and the subsequently discovered facts are such that they would have affected his report had they been known to him at the date of his report, he should refer to section 561, because certain provisions of that section may be relevant to his consideration of those matters (see section 722.34). [Reference changed by the issuance of Statement on Auditing Standards No. 71.]
- b. If the accountant has not reported on a review of the unaudited financial statements or interim financial information, he should modify his report on the audited financial statements to describe the departure from generally accepted accounting principles contained in the unaudited financial statements or interim financial information.

In either case, the accountant should also consider, probably with the advice of his legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement.

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[The next page is 1341.]

## AU Section 9711

# Filings Under Federal Securities Statutes: Auditing Interpretations of Section 711

### 1. Subsequent Events Procedures for Shelf Registration Statements Updated after the Original Effective Date

**.01 Question**—Temporary Rule 415 of Regulation C under the Securities Act of 1933 (1933 Act) permits companies to register a designated amount of securities for continuous or delayed offerings by filing one “shelf” registration statement with the SEC. Under this rule, a registrant can register an amount of securities it reasonably expects to offer and sell within the next two years, generally without the later need to prepare and file a new prospectus and registration statement for each sale.

**.02** A Rule 415 shelf registration statement can be updated after its original effective date by—

- a. The filing of a post-effective amendment,
- b. The incorporation by reference of subsequently filed material, or
- c. The addition of a supplemental prospectus (sometimes referred to as a “sticker”).

**.03** Section 711, *Filings Under Federal Securities Statutes*, paragraph .05, states, “Because a registration statement under the Securities Act of 1933 speak as of an effective date, the independent accountant whose report is included in such a registration statement has a statutory responsibility that is determined in the light of the circumstances on that date.” The independent accountant’s statutory responsibility regarding information covered by his report and included in a registration statement is specified in Section 11 of the 1933 Act. Section 11 states that the accountant will not be held liable if he can sustain a burden of proof that “he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” To sustain the burden of proof that he has made a “reasonable investigation” as of the effective date, the accountant performs subsequent events procedures (as described in section 711.10 and .11) to a date as close to the effective date of the registration statement as is reasonable and practicable in the circumstances.

**.04** In connection with Rule 415 shelf registrations, under what circumstances does the independent accountant have a responsibility to perform subsequent events procedures after the original effective date of the registration statement?

**.05 Interpretation**—As discussed in more detail below, in general, the accountant should perform the subsequent events procedures described in section 711.10 and .11, when either:

- a. A post-effective amendment to the shelf registration statement, as defined by SEC rules, is filed pursuant to Item 512(a) of Regulation S-K,<sup>1</sup> or
- b. A 1934 Act filing that includes or amends audited financial statements is incorporated by reference into the shelf registration statement.

.06 When a post-effective amendment is filed pursuant to the registrant's undertaking required by Item 512 of Regulation S-K, a shelf registration statement is considered to have a new effective date because Item 512(a)(2) of Regulation S-K states, "... for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement. ..." Accordingly, in such cases, the accountant should perform subsequent events procedures to a date as close to the new effective date of the registration statement as is reasonable and practicable in the circumstances.

.07 Item 512(b) of Regulation S-K states that for purposes of determining any liability under the Securities Act of 1933 each filing of a registrant's annual report (Form 10-K) and each filing of an employee benefit plan annual report (Form 11-K) that is incorporated by reference into a shelf registration statement is deemed to be a new registration statement relating to the securities offering. Accordingly, when a Form 10-K or Form 11-K is incorporated by reference into a shelf registration statement, the accountant should perform subsequent events procedures to a date as close to the date of the filing of the Form 10-K or Form 11-K as is reasonable and practicable in the circumstances and date his consent as of that date.

.08 In many circumstances, a Form 10-Q, Form 8-K, or other 1934 Act filing can be incorporated by reference into a shelf registration statement (sometimes this occurs automatically—for example, in a Form S-3 or Form S-8) without the need for a post-effective amendment. In those circumstances, the accountant has no responsibility to perform subsequent events procedures unless the filing includes or amends audited financial statements—for example, a Form 8-K that includes audited financial statements of an acquired company. In these latter circumstances, when the filing is incorporated into a registration statement, SEC rules require a currently dated consent of the accountant who audited those statements, and that accountant should perform subsequent events procedures to a date as close to the date of the incorporation by reference of the related material as is reasonable and practicable in the circumstances.<sup>2</sup>

.09 In addition, an accountant's report on a review of interim financial information contained in a Form 10-Q may also include his report on the information presented in the condensed year-end balance sheet that has also been included in the form and has been derived from the latest audited annual balance sheet. (See section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*, paragraph .08.) When the Form 10-Q is incorporated by reference into the shelf registration (which may occur automatically),

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<sup>1</sup> Item 512(a) of Regulation S-K provides that the registrant is required to undertake to file a post-effective amendment to a shelf registration statement to (a) file updated financial statements pursuant to section 10(a)(3) of the Securities Act of 1933, (b) reflect a "fundamental change" in the information in the registration statement arising from facts or events occurring after the effective date of the registration statement or previous post-effective amendments, or (c) include new material information regarding the plan of distribution.

<sup>2</sup> Typically in such cases, the affected audited financial statements are not those of the registrant, and accordingly, there would be no requirement for the registrant's auditor to update his subsequent events procedures with respect to the registrant's financial statements.



the report on the year-end condensed balance sheet may be considered a report of an “expert.” Because it is not clear what the accountant’s responsibility is in those circumstances, the accountant should perform subsequent events procedures (as described in section 711.10 and .11) to a date as close to the date of the incorporation by reference of the Form 10-Q as is reasonable and practicable in the circumstances.

.10 One of the subsequent events procedures described in section 711 is to “read the entire prospectus and other pertinent portions of the registration statement.” The reading of the entire prospectus (including any supplemental prospectuses and documents incorporated by reference—such as Form 10-Ks, 10-Qs, and 8-Ks) and the other procedures described in section 711.10 and .11, help assure that the accountant has fulfilled his statutory responsibilities under the 1933 Act to perform a “reasonable investigation.”

.11 When a shelf registration statement is updated by a supplemental prospectus (or “sticker”), the effective date of the registration statement is considered to be unchanged since the supplemental prospectus does not constitute an amendment to the registration statement, and, consequently, no post-effective amendment has been filed. Accordingly, an accountant has no responsibility to update his performance of subsequent events procedures through the date of the supplemental prospectus or sticker. The accountant, however, may nevertheless become aware that facts may have existed at the date of his report that might have affected his report had he then been aware of those facts. Section 711.12 and .13, provide guidance on the accountant’s response to subsequent events and subsequently discovered facts.

[Issue Date: May, 1983.]

## **2. Consenting to Use of Audit Report in an Offering Document Other Than Those Registered Under the Securities Act of 1933**

.12 *Question*—Should the auditor consent to be named, or referred to, as an expert in an offering document in connection with securities offerings other than those registered under the Securities Act of 1933 (the Act)?

.13 *Answer*—No. The term “expert” has a specific statutory meaning under the Act.<sup>3</sup> The Act states that anyone who purchases a security registered under the Act may sue specified persons if the registration statement contains an untrue statement or omits to state a material fact. Those persons who may be sued include “every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement.” These persons are typically referred to as “experts.” Auditors sign a statement, known as a consent, in which they agree to be identified as experts in a section of the registration statement.

.14 Outside the 1933 Act arena, however, the term “expert” is typically undefined and the auditor’s responsibility, as a result of the use of that term, is also undefined.

.15 When a client wishes to make reference to the auditor’s role in an offering document in connection with a securities offering that is not registered under the Act, the caption “Independent Auditors” should be used to title that section of the document; the caption “Experts” should not be used, nor should

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<sup>3</sup> If the term “expert” is defined under the applicable state law, for instance, the accountant may agree to be named as an expert in an offering document for an intra-state securities offering.

the auditors be referred to as experts anywhere in the document. The following paragraph should be used to describe the auditor's role.

Independent Auditors

The financial statements as of December 31, 19XX and for the year then ended, included in this offering circular, have been audited by ABC, independent auditors, as stated in their report(s) appearing herein.

If the client refuses to delete from the offering document the reference to the auditors as experts, the auditor should not permit inclusion of the auditor's report in the offering document.

[Issue Date: June, 1992.]

**3. Consenting to Be Named in an Offering Document in Connection With Securities Offerings Other Than Those Registered Under the Securities Act of 1933**

**.16 Question**—May the auditor consent to the use of his or her audit report in an offering document other than one registered under the Securities Act of 1933?

**.17 Answer**—When an auditor's report is included in an offering document other than one registered under the Securities Act of 1933, it is not usually necessary for the accountant to provide a consent. If the accountant is requested to provide a consent, he or she may do so. The following is example language the accountant might use:

We agree to the inclusion in this offering circular of our report, dated February 5, 19XX, on our audit of the financial statements of [name of entity].

[Issue Date: June, 1992.]

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## AU Section 722

### ***Interim Financial Information***

(Supersedes SAS Nos. 36 and 66)

Source: SAS No. 71.

Effective for interim periods within fiscal years beginning after September 15, 1992.

#### **Introduction**

.01 This section provides guidance on the nature, timing, and extent of procedures to be applied by the independent accountant in conducting a review of interim financial information, as defined in paragraph .02, and on the reporting applicable to such engagements. It also establishes certain communication requirements for an accountant who has been engaged to perform certain services related to interim financial information, as described in paragraph .05.

.02 For purposes of this section, the term *interim financial information or statements* means financial information or statements for less than a full year or for a twelve-month period ending on a date other than the entity's fiscal year end.

#### **Applicability**

.03 The guidance in this section applies only to—

- a. Engagements to review interim financial information or statements of a public entity<sup>1</sup> that are presented alone either in the form of financial statements or in a summarized form that purports to conform with the provisions of Accounting Principles Board (APB) Opinion No. 28 [AC section I73].<sup>2</sup>
- b. Interim financial information that accompanies, or is included in a note to, audited financial statements of a public entity.
- c. Interim financial information that is included in a note to the audited financial statements of a nonpublic entity.<sup>3</sup>

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<sup>1</sup> For purposes of this section, a public entity is any entity (a) whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally), (b) that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (c) that is a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b) (see section 504, *Association With Financial Statements*). When a public entity does not have its annual financial statements audited, an accountant may be requested to review its annual or interim financial statements. In those circumstances, an accountant may make a review and, if so, should refer to the guidance in Statements on Standards for Accounting and Review Services (SSARs) for the standards, procedures, and form of report applicable to such an engagement.

<sup>2</sup> SSARs provide guidance in connection with the unaudited financial statements of a nonpublic entity.

<sup>3</sup> Nonpublic entities frequently include interim financial information as supplementary information.

If that information is included in an auditor-submitted document that contains basic financial statements, the accountant should refer to section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, for guidance.

.04 This section also provides guidance on reporting by the independent auditor when certain selected quarterly financial data required to be presented with audited annual financial statements by item 302(a) of Regulation S-K of the Securities and Exchange Commission (SEC) are not presented or are presented but have not been reviewed (see paragraph .41 for guidance).<sup>4</sup>

.05 The guidance requiring certain communications as described in paragraphs .20 through .22 applies only when (a) the accountant's report accompanied the entity's most recent audited annual financial statements filed with a specified regulatory agency,<sup>5</sup> or the accountant has been engaged to audit the entity's annual financial statements for the current period, as stated in a document filed by the entity with a specified regulatory agency, and (b) the accountant is engaged—

- a. To assist the entity in preparing its interim financial information, or
- b. To perform any of the procedures described in paragraph .13 on the interim financial information. However, mere reading of the interim financial information does not constitute a procedure sufficient to require consideration of the communication requirements described in paragraphs .20 through .22.

.06 This section does not apply to comparative presentations of audited and unaudited financial data as discussed in section 504.14 through .17.

## Understanding With the Client

.07 A clear understanding should be established with the client regarding the nature of the procedures to be performed on the interim financial information. Accordingly, the accountant may wish to confirm the nature and scope of his or her engagement in a letter to the client. The letter usually would include (a) a general description of the procedures, (b) an explanation that such procedures are substantially less in scope than an audit performed in accordance with generally accepted auditing standards, (c) an explanation that the financial information is the responsibility of the company's management, and (d) a description of the form of the report, if any.

## Characteristics of Interim Financial Information

.08 The characteristics of interim financial information necessarily affect the nature, timing, and extent of procedures that the accountant applies in conducting a review of that information. Timeliness is an important element of interim financial reporting. Interim financial information customarily is made available to investors and others more promptly than is annual financial information. Timely reporting of interim financial information ordinarily precludes the development by management of information and documentation underlying interim financial information to the same extent as that underlying

(Footnote Continued)

If the information is included in a client-prepared document that contains audited financial statements, the auditor should refer to the guidance in section 550, *Other Information in Documents Containing Audited Financial Statements*; if the information included in the client-prepared document is a complete set of financial statements, the accountant may perform a review in accordance with SSARs and report thereon.

<sup>4</sup> Additional considerations for the accountant when unaudited interim financial information is presented or incorporated by reference in a filing under the Securities Act of 1933 are described in section 711, *Filings Under Federal Securities Statutes*. The accountants' involvement with such information in a comfort letter is described in section 634, *Letters for Underwriters*.

<sup>5</sup> For purposes of this section, specified regulatory agencies are the SEC and the following agencies with which an entity files periodic reports pursuant to the Securities Exchange Act of 1934: Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve System, and Office of Thrift Supervision.

ing annual financial information. Therefore, a characteristic of interim financial information is that many revenues, costs, and expenses are estimated to a greater extent than for annual reporting purposes. Another characteristic of interim financial information is its relationship to annual financial information. Deferrals, accruals, and estimates at the end of each interim period are frequently affected by judgments made at interim dates concerning anticipated results of operations for the remainder of the annual period.

## **Objective of a Review of Interim Financial Information**

.09 The objective of a review of interim financial information is to provide the accountant, based on applying his or her knowledge of financial reporting practices to significant accounting matters of which he or she becomes aware through inquiries and analytical procedures, with a basis for reporting whether material modifications should be made for such information to conform with generally accepted accounting principles. The objective of a review of interim financial information differs significantly from the objective of an audit of financial statements in accordance with generally accepted auditing standards. The objective of an audit is to provide a reasonable basis for expressing an opinion regarding the financial statements taken as a whole. A review of interim financial information does not provide a basis for the expression of such an opinion, because the review does not contemplate (a) tests of accounting records through inspection, observation, or confirmation, (b) obtaining corroborating evidential matter in response to inquiries, or (c) the application of certain other procedures ordinarily performed during an audit. A review may bring to the accountant's attention significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit.

## **The Accountant's Knowledge of Internal Control Structure Policies and Procedures**

.10 To perform a review of interim financial information, the accountant needs to have sufficient knowledge of a client's internal control structure policies and procedures as they relate to the preparation of both annual and interim financial information to—

- Identify types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence.
- Select the inquiries and analytical procedures that will provide the accountant with a basis for reporting whether material modifications should be made for such information to conform with generally accepted accounting principles.

Knowledge of the client's internal control structure includes knowledge of the control environment, the accounting system, and, to the extent appropriate, control procedures. Sufficient knowledge of a client's internal control structure policies and procedures as they relate to the preparation of annual financial information would ordinarily have been acquired, and may have been acquired with respect to interim financial information, by the accountant who has audited a client's financial statements for one or more annual periods. When the accountant has not audited the most recent annual financial statements, and thus has not acquired sufficient knowledge of the entity's internal control structure policies and procedures, the accountant should perform procedures to obtain that knowledge.

.11 If the internal control structure appears to contain deficiencies so significant that it is impracticable for the accountant to effectively apply his or her knowledge of accounting and financial reporting practices to the interim financial information, the accountant should consider whether this precludes completion of such a review (see paragraph .26).

## **Procedures for a Review of Interim Financial Information**

.12 The procedures for a review of interim financial information are described in the following paragraphs concerning (a) the nature of procedures (paragraph .13), (b) the timing of procedures (paragraph .14), and (c) the extent of procedures (paragraphs .15 through .19).

### **Nature of Procedures**

.13 Procedures for conducting a review of interim financial information generally are limited to inquiries and analytical procedures, rather than search and verification procedures, concerning significant accounting matters relating to the financial information to be reported. The procedures that the accountant ordinarily should apply are—

- a. Inquiry concerning (1) the internal control structure, including the control environment, the accounting system, and, to the extent appropriate, control procedures, for both annual and interim financial information, and (2) any significant changes in the internal control structure since the most recent financial statement audit or review of interim financial information to ascertain the potential effect of (1) and (2) on the preparation of interim financial information.
- b. Application of analytical procedures to interim financial information to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual. Analytical procedures, for purposes of this section, consist of (1) comparison of the interim financial information with comparable information for the immediately preceding interim period and for corresponding previous period(s), (2) evaluations of the interim financial information made by consideration of plausible relationships among both financial and, where relevant, nonfinancial data, and (3) comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the accountant. The accountant develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:
  - Financial information for comparable prior period(s) giving consideration to known changes
  - Anticipated results—for example, budgets or forecasts including extrapolations from interim or annual data
  - Relationships among elements of financial information within the period
  - Information regarding the industry in which the client operates—for example, gross margin information

- Relationships of financial information with relevant nonfinancial information

In applying these procedures, the accountant should consider the types of matters that, in the preceding year or quarters, have required accounting adjustments. The accountant may find the guidance in section 329, *Analytical Procedures*, useful in performing a review of interim financial information. Section 329 provides guidance on the use of analytical procedures in a financial statement audit and requires the auditor to obtain corroborating evidential matter when analytical procedures are used as a substantive test. The accountant ordinarily would not obtain corroborating evidential matter of management's responses to the accountant's inquiries in performing a review of interim financial information. The accountant should, however, consider the consistency of management's responses in light of the results of other inquiries and the application of analytical procedures. Since many revenues, costs, and expenses are estimated to a greater extent in interim financial information than for annual financial reporting purposes, the accountant may wish to refer to the guidance in section 342, *Auditing Accounting Estimates*, paragraphs .05 and .06.

- c. Reading the minutes of meetings of stockholders, the board of directors, and committees of the board of directors to identify actions that may affect the interim financial information.
- d. Reading the interim financial information to consider whether, on the basis of information coming to the accountant's attention, the information to be reported conforms with generally accepted accounting principles.
- e. Obtaining reports from other accountants, if any, who have been engaged to make a review of the interim financial information of significant components of the reporting entity, its subsidiaries, or its other investees.<sup>6</sup>
- f. Inquiry of officers and other executives having responsibility for financial and accounting matters concerning (1) whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied, (2) changes in the entity's accounting practices, (3) changes in the entity's business activities, (4) matters about which questions have arisen in the course of applying the foregoing procedures, and (5) events subsequent to the date of the interim financial information that would have a material effect on the presentation of such information.
- g. Obtaining written representations from management concerning its responsibility for the financial information, completeness of minutes, subsequent events, and other matters about which the accountant believes written representations are appropriate in the

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<sup>6</sup> When an accountant acts as principal auditor (see section 543, *Part of Audit Performed by Other Independent Auditors*) and makes use of the work or reports of other auditors in the course of the annual audit of the client's financial statements, the accountant ordinarily will be in a similar position in connection with a review of interim financial information. Thus, the accountant should take into account the same considerations in deciding whether to refer in his or her review report to the review performed by the other accountants.

circumstances. See section 333, *Client Representations*, for guidance concerning client representations.

### Timing of Procedures

.14 Adequate planning by the accountant is essential to the timely completion of a review of interim financial information. Performance of some of the work before the end of the interim period may permit the work to be carried out in a more efficient manner and to be completed at an earlier date. Performing some of the work earlier in the interim period also permits early consideration of significant accounting matters affecting the interim financial information.

### Extent of Procedures

.15 The extent to which the procedures referred to in paragraph .13 are applied depends on the considerations described in paragraphs .16 through .19.

.16 *The Accountant's Knowledge of Changes in Accounting Practices or in the Nature or Volume of Business Activity.* A review of interim financial information may bring to the accountant's attention significant changes in accounting practices or in the nature or volume of the client's business activities. Examples of changes that could affect the interim financial information to be reported include business combinations; disposal of a segment of the business; extraordinary, unusual, or infrequently occurring transactions; significant changes in related parties or related-party transactions; initiation of litigation or the development of other contingencies; trends in sales or costs that could affect accounting estimates relating to the valuations of receivables and inventories, realization of deferred charges, provisions for warranties and employee benefits, and unearned income; and changes in accounting principles or in the methods of applying them. If any such changes come to the accountant's attention, he or she should inquire about the manner in which the changes and their effects are to be reported in the interim financial information.

.17 *Inquiry Concerning Litigation, Claims, and Assessments.* A review of interim financial information does not involve obtaining corroborating evidential matter for responses to inquiries as a basis for issuing an unmodified accountant's report (see paragraph .09). Consequently, it ordinarily is not necessary to send an audit inquiry letter to a client's lawyer concerning litigation, claims, and assessments. However, if information comes to the accountant's attention that leads him or her to question whether the unaudited interim financial information departs from generally accepted accounting principles insofar as litigation, claims, or assessments may be concerned, and the accountant believes the client's lawyer may have information concerning that question, an inquiry of the lawyer concerning the specific question is appropriate.

.18 *Questions Raised in Performing Other Procedures.* If, in performing a review of interim financial information, the accountant becomes aware of information that leads him or her to question whether the interim financial information to be reported conforms with generally accepted accounting principles, the accountant should make additional inquiries or employ other procedures he or she considers appropriate in order to provide the limited assurance for a review engagement.

.19 *Modification of Review Procedures.* The procedures for a review of interim financial information may be modified, as appropriate, to take into



consideration the results of auditing procedures applied in an audit conducted in accordance with generally accepted auditing standards.

## Communication With Audit Committees

.20 As a result of performing the services described in paragraph .05, the accountant may become aware of matters that cause him or her to believe that interim financial information, filed or to be filed with a specified regulatory agency, is probably materially misstated as a result of a departure from generally accepted accounting principles. In such circumstances, the accountant should discuss the matters with the appropriate level of management as soon as practicable.

.21 If, in the accountant's judgment, management does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should inform the audit committee, or others with equivalent authority and responsibility (hereafter referred to as the audit committee), of the matters as soon as practicable. This communication may be oral or written. If information is communicated orally, the accountant should document the communication in appropriate memoranda or notations in the working papers.

.22 If, in the accountant's judgment, the audit committee does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should evaluate (a) whether to resign from the engagement related to the interim financial information, and (b) whether to remain as the entity's auditor or stand for reelection to audit the entity's financial statements. The accountant may wish to consult with his or her attorney when making these evaluations.

.23 In performing the procedures in paragraphs .13 through .19, the accountant may become aware of irregularities or illegal acts by clients. The accountant should assure himself or herself that the audit committee is adequately informed about—

- a. Any irregularities of which the accountant becomes aware during the review, unless those irregularities are clearly inconsequential. (See section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraphs .28 and .29.)
- b. Any illegal acts of which the accountant becomes aware during the review, unless those illegal acts are clearly inconsequential. (See section 317, *Illegal Acts by Clients*, paragraph .17.)

.24 In performing the procedures in paragraphs .13 through .19, the accountant may become aware of matters relating to the internal control structure that may be of interest to the audit committee. The matters required for reporting to the audit committee are referred to as reportable conditions. Specifically, these are matters coming to the accountant's attention that, in his or her judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the interim financial information. The accountant may also wish to submit recommendations for other matters of significance that come to the accountant's attention.<sup>7</sup>

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<sup>7</sup> Section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit*, provides guidance with respect to communicating reportable conditions in the internal control structure.

.25 In performing the procedures in paragraphs .13 through .19, the accountant also should consider whether any of the matters described in section 380, *Communication With Audit Committees*, as they relate to the interim financial information, should be communicated to the audit committee. For instance, the accountant should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates or about a change in a significant accounting policy affecting the interim financial information.

## **The Accountant's Report on a Review of Interim Financial Information**

.26 An accountant may permit the use of his or her name and inclusion of his or her report in a written communication setting forth interim financial information if he or she has made a review of such information as specified in the preceding paragraphs. If restrictions on the scope of a review of interim financial information preclude completion of such a review, the accountant should not permit the use of his or her name.<sup>8</sup> Restrictions on the scope of the review may be imposed by a client or may be caused by such circumstances as the timing of the accountant's work or an inadequacy in the accounting records.

### **Form of Accountant's Review Report**

.27 The accountant's report accompanying interim financial information that he or she has reviewed should consist of—

- a. A title that includes the word *independent*.
- b. Identification of the interim financial information reviewed.
- c. A statement that the financial information is the responsibility of the company's management.
- d. A statement that the review of interim financial information was conducted in accordance with standards established by the AICPA.
- e. A description of the procedures for a review of interim financial information.
- f. A statement that a review of interim financial information is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is an expression of opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.
- g. A statement about whether the accountant is aware of any material modifications that should be made to the accompanying financial information so that it conforms with generally accepted accounting principles.
- h. The manual or printed signature of the accountant's firm.
- i. The date of the review report. The report may be addressed to the company whose financial information is being reviewed, its board of directors, or its stockholders. Generally, the report should be dated

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<sup>8</sup> See paragraph .35 concerning a client's representation when the scope of a review of interim financial information has been restricted. Also, when the accountant is unable to complete such a review because of a scope limitation, he or she should consider the implications of that limitation with respect to the interim financial information issued by the client. In those circumstances, the accountant should also refer to paragraph .24 for guidance.

as of the date of completion of the review.<sup>9</sup> In addition, each page of the interim financial information should be clearly marked as unaudited.

.28 An example of such a report follows:<sup>10</sup>

Independent Accountant's Report

We have reviewed the accompanying [*describe the statements or information reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 19X1, and for the three-month and nine-month periods then ended. These financial statements (information) are (is) the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements (information) for them (it) to be in conformity with generally accepted accounting principles.

[*Signature* ]

[*Date* ]

.29 The accountant may use and make reference to the report of another accountant on a review of interim financial information of a significant component of the reporting entity. This reference indicates a division of responsibility for performance of the review.<sup>11</sup> An example of a report including such a reference follows:

Independent Accountant's Report

We have reviewed the accompanying [*describe the statements or information reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 19X1, and for the three-month and nine-month periods then ended. These financial statements (information) are (is) the responsibility of the company's management.

We were furnished with the report of other accountants on their review of the interim financial information of ADE subsidiary, whose total assets as of September 30, 19X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of

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<sup>9</sup> Other reporting issues involved in the dating of reports or concerning subsequent events are similar to those encountered in an audit of financial statements (see section 530, *Dating of the Independent Auditor's Report*).

<sup>10</sup> If interim financial information of a prior period is presented with that of the current period and the accountant has conducted a review of that information, the accountant should report on his or her review of the prior period. An example of the first sentence of such a report follows: "We have reviewed . . . of ABC Company and consolidated subsidiaries as of September 30, 19X1 and 19X2, and for the three-month and nine-month periods then ended. . . ."

<sup>11</sup> See section 543.

which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying financial statements (information) for them (it) to be in conformity with generally accepted accounting principles.

[Signature]

[Date]

## Modification of the Accountant's Review Report

**.30** The accountant's report on a review of interim financial information should be modified for departures from generally accepted accounting principles,<sup>12</sup> which include inadequate disclosure and any changes in accounting principle that are not in conformity with generally accepted accounting principles. The existence of an uncertainty, substantial doubt about the entity's ability to continue as a going concern, or a lack of consistency in the application of accounting principles affecting interim financial information would not require the accountant to include an additional paragraph in the report, provided that the interim financial information appropriately discloses such matters. Although not required, the accountant may wish to emphasize such matters in a separate paragraph of the report.

**.31 *Departure From Generally Accepted Accounting Principles.*** If the accountant becomes aware that the interim financial information is materially affected by a departure from generally accepted accounting principles, he or she should modify the report. The modification should describe the nature of the departure and, if practicable, should state the effects on the interim financial information. An example of such a modification of the accountant's report follows:

### [Explanatory third paragraph]

Based on information furnished us by management, we believe that the company has excluded from property and debt in the accompanying balance sheet certain lease obligations that should be capitalized to conform with generally accepted accounting principles. This information indicates that if these lease obligations were capitalized at September 30, 19X1, property would be increased by \$\_\_\_\_\_, long-term debt by \$\_\_\_\_\_, and net income and earnings per share would be increased (decreased) by \$\_\_\_\_\_, \$\_\_\_\_\_, \$\_\_\_\_\_, and \$\_\_\_\_\_, respectively, for the \_\_\_\_\_ and \_\_\_\_\_ periods then ended.

### [Concluding paragraph]

Based on our review, with the exception of the matter(s) described in the preceding paragraph(s), we are not aware of any material modifications that should be made to the accompanying financial statements (information) for them (it) to be in conformity with generally accepted accounting principles.

**.32 *Inadequate Disclosure.*** The information the accountant will conclude is necessary for adequate disclosure will be influenced by the form and context in which the interim financial information is presented. For example, the disclosures considered necessary for interim financial information presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30 [AC section I73.146], are considerably less extensive than those necessary for annual financial statements that present financial position, results of operations, and cash flows in conformity with generally accepted

<sup>12</sup> When the circumstances contemplated by Rule 203 [ET section 203.01] are present, the accountant should refer to the guidance in section 508, *Reports on Audited Financial Statements*, paragraph .15.

accounting principles.<sup>13</sup> If information that the accountant believes is necessary for adequate disclosure in conformity with generally accepted accounting principles is not included in the interim financial information, the accountant should modify the report and, if practicable, include the necessary information. An example of such a modification of the accountant's report follows:

*[Explanatory third paragraph]*

Management has informed us that the company is presently contesting deficiencies in federal income taxes proposed by the Internal Revenue Service for the years 19XX through 19XY in the aggregate amount of approximately \$—, and that the extent of the company's liability, if any, and the effect on the accompanying statements (information) are (is) not determinable at this time. The statements (information) fail(s) to disclose these matters, which we believe are required to be disclosed in conformity with generally accepted accounting principles.

*[Concluding paragraph]*

Based on our review, with the exception of the matter(s) described in the preceding paragraph(s), we are not aware of any material modifications that should be made to the accompanying financial statements (information) for them (it) to be in conformity with generally accepted accounting principles.

## **Other Information in Documents Containing Interim Financial Information**

.33 An entity may publish various documents that contain information in addition to interim financial information and the independent accountant's review report on that interim financial information. Under those circumstances, the accountant<sup>14</sup> may wish to refer to the guidance in section 550.

## **Subsequent Discovery of Facts Existing at the Date of the Accountant's Report**

.34 Subsequent to the date of the accountant's review report, the accountant may become aware that facts existed at the date of the review report that might have affected the report had the accountant then been aware of those facts. Because of the variety of conditions that might be encountered, the specific actions to be taken by the accountant in a particular case may vary with the circumstances. In any event, the accountant should consider the guidance in section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

## **Client's Representation Concerning a Review of Interim Financial Information**

.35 The accountant may be requested to conduct a review of interim financial information to permit the client to include a representation to that effect in documents issued to stockholders or third parties or in Form 10-Q, a quarterly report required to be submitted to the SEC pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934. If the client represents in such a document setting forth interim financial information that the accountant has made a review of that information, the accountant should request that his or

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<sup>13</sup> APB Opinion No. 28, paragraph 32 [AC section 173.148], states that "there is a presumption that users of summarized interim financial data will have read the latest published annual report, including the financial disclosures required by generally accepted accounting principles and management's commentary concerning the annual financial results, and that the summarized interim data will be viewed in that context."

<sup>14</sup> The principal accountant may also request the other accountant or accountants involved in the engagement to read the other information.

her report be included.<sup>15</sup> If the client will not agree to include the accountant's report or if the accountant has been unable to complete the review (see paragraph .26), the accountant should request that neither his or her name be associated with the interim financial information nor reference to him or her be made in the document. If the client does not comply, the accountant should advise the client that the accountant does not consent, either to the use of his or her name or to reference to him or her, and should consider what other actions might be appropriate.<sup>16</sup>

## **Interim Financial Information Accompanying Audited Financial Statements**

### **Presentation of the Information and Application of Review Procedures**

.36 Certain entities are required by item 302(a) of SEC Regulation S-K to include selected quarterly financial data in their annual reports or other documents filed with the SEC that contain audited financial statements.<sup>17</sup> If the independent accountant has audited the financial statements of annual periods for which selected quarterly financial data specified by Regulation S-K are required to be presented, he or she should apply the review procedures specified in paragraphs .13 through .19 to the selected quarterly financial data. The reporting guidance in paragraph .41 is appropriate if the independent accountant has not performed such a review.

.37 Other entities may voluntarily include in documents containing audited financial statements the selected quarterly financial data specified in item 302(a) of SEC Regulation S-K. When a public entity voluntarily includes such information, the procedures specified in paragraphs .13 through .19 are applicable, unless either the entity indicates that the quarterly data have not been reviewed or the auditor expands his or her report on the audited financial statements to state that the data have not been reviewed (see paragraph .42).<sup>18</sup>

.38 The interim financial information ordinarily would be presented as supplementary information outside the audited financial statements. Each page of the interim financial information should be clearly marked as unaudited. If management chooses to present the interim financial information in a note to the audited financial statements, the information should also be clearly marked as unaudited.

.39 The accountant may perform the review procedures either at the time of an audit of the annual financial statements or quarterly before the issuance of the data. Performance of the procedures before issuance permits early consideration of significant accounting matters affecting the interim financial information and early modification of accounting procedures that the account-

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<sup>15</sup> SEC regulations require that if the client includes a representation that the independent accountant has conducted a review, the accountant's report on the review must accompany the interim financial information.

<sup>16</sup> In considering what actions, if any, may be appropriate in these circumstances, the accountant may wish to consult his or her legal counsel.

<sup>17</sup> Item 302(a), "Supplementary Financial Information—Selected Quarterly Financial Data," states, in part, "Disclosure shall be made of net sales, gross profit . . . , income (loss) before extraordinary items and cumulative effect of a change in accounting, per share data based upon such income (loss), and net income (loss) for each full quarter within the two most recent fiscal years and any subsequent interim period for which financial statements are included or are required to be included. . . ."

<sup>18</sup> If the interim financial information is included in an auditor-submitted document, the auditor should refer to section 551, for guidance.

ant believes might be improved. If review procedures are performed before the issuance of the quarterly data, they need not be repeated at the time an audit is performed.

### **Circumstances Requiring Modification of the Auditor's Report**

**.40** The auditor ordinarily need not modify the report on the audited financial statements to refer to his or her review or to refer to the interim financial information. The interim financial information has not been audited and is not required for presentation of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Accordingly, the auditor need not report on the review of the interim financial information accompanying the audited financial statements.

**.41 *Quarterly Data Required by SEC Regulation S-K.*** The auditor's report on the audited financial statements should be expanded, however, if the selected quarterly financial data required by item 302(a) of Regulation S-K (a) are omitted or (b) have not been reviewed. For example, if the selected quarterly financial data required by item 302(a) are omitted, the auditor's report should include an additional paragraph, which might be worded as follows:

The company has not presented the selected quarterly financial data, specified by item 302(a) of Regulation S-K, that the Securities and Exchange Commission requires as supplementary information to the basic financial statements.

If the selected quarterly financial data required by item 302(a) have not been reviewed, the auditor's report should include an additional paragraph, which might be worded as follows:

The selected quarterly financial data on page xx contain information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with standards established by the American Institute of Certified Public Accountants because we believe that the company's internal control structure policies and procedures for the preparation of interim financial information do not provide an adequate basis to enable us to complete such a review.

**.42 *Voluntary or Required Presentations of Interim Financial Information.*** The auditor's report on the audited financial statements should also be expanded in any of the following circumstances:

- a. Interim financial information included in a note to the financial statements of a public or nonpublic entity, including information that has been reviewed in accordance with the procedures specified in paragraphs .13 through .19, is not appropriately marked as unaudited.
- b. Item 302(a) information that has not been reviewed is voluntarily presented by a public entity in a client-prepared document containing audited financial statements, and the information is not appropriately marked as not reviewed.
- c. The interim financial information in a or b does not appear to be presented in conformity with generally accepted accounting principles (see paragraphs .30 through .32).
- d. The interim financial information includes an indication that a review was made but fails to state that the review is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is an expression

of opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.

The auditor need not expand his or her report on the audited financial statements in the circumstances described in *c* and *d* if his or her separate review report, which refers to those circumstances, is presented with the information.

### **Other Matters**

.43 It is not possible to specify the form or the content of the working papers the accountant should prepare in connection with a review of interim financial information because of the different circumstances of individual engagements. Ordinarily, the working papers should document the performance and results of the procedures set forth in paragraphs .13 through .19. See section 339, *Working Papers*, for further guidance concerning working papers.

### **Effective Date**

.44 This section is effective for interim periods within fiscal years beginning after September 15, 1992. Reports issued or reissued after September 15, 1992 (including engagements based on procedures under SAS No. 36), should conform with the reporting guidance in this section. Earlier application is encouraged.

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## AU Section 800

# COMPLIANCE AUDITING

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... governmental entities and other recipients of governmental financial assistance ...

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## AU Section 801

# ***Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance***

(Supersedes SAS No. 63)

Source: SAS No. 68.

Effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after June 15, 1992, unless otherwise indicated.

## **Introduction and Applicability**

.01 This section establishes standards for testing and reporting on compliance with laws and regulations in engagements, as defined below, under generally accepted auditing standards (GAAS); *Government Auditing Standards*; the Single Audit Act of 1984 and Office of Management and Budget (OMB) Circular A-128, "Audits of State and Local Governments"; and OMB Circular A-133, "Audits of Institutions of Higher Education and Other Non-profit Institutions." It also addresses reporting on the internal control structure under *Government Auditing Standards*. Specifically, this section provides guidance on the auditor's responsibility to—

- a. Apply the provisions of section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and section 317, *Illegal Acts by Clients*, relative to detecting misstatements resulting from illegal acts related to laws and regulations that—
  - Have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities (paragraphs .09 through .15).
  - Apply to governmental financial assistance and that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of nongovernmental entities (paragraphs .16 and .17).
- b. Report on compliance with laws and regulations and on the internal control structure in audits conducted in accordance with *Government Auditing Standards* (1988 revision), issued by the Comptroller General of the United States (paragraphs .20 through .42).<sup>1</sup>
- c. Test and report on compliance with certain laws and regulations applicable to federal financial assistance programs in audits con-

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<sup>1</sup> In practice, *Government Auditing Standards* is sometimes referred to as generally accepted government auditing standards (GAGAS) or the "Yellow Book." *Government Auditing Standards* includes standards for financial audits as well as standards for performance audits. Among the matters that *Government Auditing Standards* addresses are quality control, continuing education, working papers, and audit follow-up. The references to *Government Auditing Standards* in this section encompass only the standards for financial audits, not the performance audit standards.

ducted in accordance with the federal Single Audit Act of 1984 and OMB Circular A-128 (paragraphs .43 through .92).<sup>2</sup>

- d. Test and report on compliance with certain laws and regulations applicable to federal award programs in audits conducted in accordance with OMB Circular A-133 (paragraphs .93 through .95).
- e. Establish an understanding with management regarding the type of engagement when engaged to test and report on program-specific audits or compliance with state or local laws and regulations (paragraphs .96 through .99).

.02 Management is responsible for ensuring that the entity it manages complies with the laws and regulations applicable to its activities. That responsibility encompasses identifying applicable laws and regulations and establishing internal control structure policies and procedures designed to provide reasonable assurance that the entity complies with those laws and regulations. As this section explains, the auditor's responsibility for testing and reporting on compliance with laws and regulations varies according to the terms of the engagement.

.03 Because of the variety of audit requirements to which entities receiving governmental financial assistance are subject, auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. If a proposal, contract, or engagement letter is used, an auditor may want to consider including in it a statement as to the type of engagement and whether the engagement is intended to meet a governmental oversight agency's audit requirements.

.04 Management is also responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Generally accepted auditing standards do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. Therefore, if during a GAAS audit of the financial statements the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with generally accepted auditing standards may not satisfy the relevant legal, regulatory, or contractual requirements.<sup>3</sup> For example, the auditor will be required to make this communication if an entity engages an auditor to perform an audit of its financial statements in accordance with generally accepted auditing standards and the auditor becomes aware that by law, regulation, or contractual agreement the entity also is required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*, issued by the Comptroller General of the United States

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<sup>2</sup> Certain single audit responsibilities are addressed in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* (fifth edition) and related AICPA Statements of Position and are therefore not addressed by this section. In addition, certain audit responsibilities under OMB Circular A-133 that are not addressed in this section will be addressed in a forthcoming AICPA Statement of Position. Paragraph .102 to the section presents an overview of procedures and reports required in an audit conducted in accordance with the Single Audit Act and OMB Circular A-128 or in accordance with OMB Circular A-133.

<sup>3</sup> For entities that do not have audit committees, "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, the owner in owner-managed entities, the city council, or the legislative standing committee.

- The Single Audit Act of 1984 and OMB Circular A-128, “Audits of State and Local Governments”
- OMB Circular A-133, “Audits of Institutions of Higher Education and Other Nonprofit Institutions”
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

.05 The communication required by paragraph .04 may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in section 317.

## **Compliance Auditing in Audits Conducted in Accordance With Generally Accepted Auditing Standards**

.06 In an audit performed in accordance with generally accepted auditing standards, the auditor's responsibility for consideration of laws and regulations and how they affect the audit is described in sections 317 and 316. Section 317.05, equates the auditor's responsibility for detecting misstatements caused by certain illegal acts with the responsibility for other errors and irregularities:

The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. . . . However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se. The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and irregularities as described in section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.

.07 Section 316.05, describes the auditor's responsibility for detecting errors and irregularities as follows:

The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

.08 Thus, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.<sup>4</sup> This responsibility exists for all audits conducted in accordance with generally accepted auditing standards.<sup>5</sup> Paragraphs .09 through .15 of this section address this responsibility in audits of the financial statements of government-

<sup>4</sup> Paragraph 5.05 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* (fifth edition) states that for general purpose financial statements “[e]xisting audit practice is that audit scope should be set and materiality evaluations should be applied at the fund type and account group level. . . .”

<sup>5</sup> The auditor undertakes the same responsibility in an audit of financial statements conducted in accordance with *Government Auditing Standards*.

tal entities (including federal, state, and local entities). Paragraphs .16 and .17 address audits of the financial statements of other entities that receive financial assistance from a governmental entity. Paragraphs .18 and .19, respectively, address working papers and written representations from management.

## Governmental Entities

.09 The Governmental Accounting Standards Board's *Codification of Governmental Accounting and Financial Reporting Standards* (GASB *Codification*), section 1200.103, indicates that governmental entities generally are subject to a variety of laws and regulations that affect their financial statements:

An important aspect of GAAP [generally accepted accounting principles] as applied to governments is the recognition of the variety of legal and contractual considerations typical of the government environment. These considerations underlie and are reflected in the fund structure, bases of accounting, and other principles and methods set forth here, and are a major factor distinguishing governmental accounting from commercial accounting.

.10 Paragraph .11 of this section provides guidance on obtaining an understanding of the possible effects on a governmental entity's financial statements of laws and regulations that have a direct and material effect on the determination of financial statement amounts. Paragraphs .12 through .15 provide guidance on considering the risk—including control risk—that the financial statements could include material misstatements resulting from violations of such laws and regulations.

### Understanding the Effects of Laws and Regulations

.11 The auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in a governmental entity's financial statements.<sup>6</sup> The auditor should also assess whether management has identified laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements. The auditor may consider performing the following procedures in assessing management's identification of such laws and regulations and in obtaining an understanding of their possible effects on the financial statements:

- a. Consider knowledge about such laws and regulations obtained from prior years' audits.
- b. Discuss such laws and regulations with the entity's chief financial officer, legal counsel, or grant administrators. Obtain written representation from management regarding the completeness of management's identification (see paragraph .19).
- c. Review the relevant portions of any directly related agreements, such as those related to grants and loans.
- d. Review minutes of meetings of the legislative body of the governmental entity being audited for the enactment of laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements.
- e. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about laws and regulations

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<sup>6</sup> Paragraph .103 to this section presents examples of the possible effects of certain laws and regulations on a governmental entity's financial statements.

applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.

- f. Inquire of the program administrators of the governmental entities that provided the grants about restrictions, limitations, terms, and conditions under which such grants were provided.<sup>7</sup>
- g. Review information about compliance requirements available from the state societies of CPAs or associations of governments.

### Considering Risk

.12 Section 316.09, states, “In developing an audit plan, the auditor should consider factors influencing audit risk that relate to several or all account balances and obtain an understanding of the internal control structure.”

.13 **Factors influencing audit risk.** Section 316 cites matters the auditor should consider in assessing audit risk at the financial statement level and at the balance or class level. Certain of these matters are relevant to the auditor’s consideration of the risk of material misstatement of the financial statements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. For example, if a governmental entity is decentralized without adequate monitoring, the risk of material misstatement at the financial statement level might be increased. The risk of material misstatement related to particular assertions at the balance or class level might be influenced by the nature, cause, and amount of known and likely misstatements detected in prior audits and the competence of personnel assigned to processing data that affect the balance or class.

.14 **Internal control structure.** Section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*, requires the auditor to obtain an understanding of the internal control structure that is sufficient to plan the audit and to assess control risk for the assertions embodied in the financial statements. In an audit of the financial statements of a governmental entity, this understanding includes knowledge about the design of internal control structure policies and procedures relevant to financial statement assertions affected by compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts and about whether those policies and procedures have been placed in operation.<sup>8</sup> In planning the audit, such knowledge should be used to identify types of potential misstatements, to consider factors that affect the risk of material misstatement, and to design substantive tests. The auditor’s assessment of control risk for assertions affected by compliance with such laws and regulations may be influenced by policies and procedures in all three elements of the internal control structure (control environment, accounting system, and con-

<sup>7</sup> In assessing management’s identification of requirements governing federal financial assistance programs and obtaining an understanding of their possible effects on the determination of financial statement amounts, the auditor may use as a reference source the *Compliance Supplement for Single Audits of State and Local Governments* and the *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*, issued by the Office of Management and Budget, and the *Catalog of Federal Domestic Assistance*.

<sup>8</sup> In addition, for compliance with laws and regulations that have an indirect effect on the determination of financial statement amounts, section 317 notes that, where applicable, the auditor should also inquire of management concerning—

- The client’s policies relative to the prevention of illegal acts.
- The use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations.

trol procedures). For example, the following control environment factors may influence the auditor's assessment of control risk:

- a. Management's awareness or lack of awareness of applicable laws and regulations
- b. Entity policy regarding such matters as acceptable operating practices and codes of conduct
- c. Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements

.15 The auditor should consider whether any noted deficiencies in such internal control structure policies and procedures should be reported in accordance with section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit*.

### **Other Entities That Receive Governmental Financial Assistance**

.16 Federal, state, and local governmental entities provide financial assistance to other entities, including not-for-profit organizations and business enterprises. Among the forms of governmental financial assistance are grants of cash and other assets, loans, loan guarantees, and interest rate subsidies.<sup>9</sup> By accepting such assistance, both governmental and nongovernmental entities may be subject to laws and regulations that may have a direct and material effect on the determination of amounts in their financial statements. Such laws and regulations may deal with the following matters:

- a. *Types of services allowed or not allowed*—specifies the types of goods or services entities may purchase with financial assistance
- b. *Eligibility*—specifies the characteristics of individuals or groups to which entities may give financial assistance
- c. *Matching, level of effort, or earmarking*—specifies amounts entities should contribute from their own resources towards projects for which financial assistance is provided
- d. *Allowable costs/cost principles*—specifies principles and standards for determining costs applicable to federal financial assistance programs

.17 The auditor's responsibility to detect material misstatements of financial statements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts is addressed in paragraphs .06 through .08 of this section. In carrying out this responsibility in an audit of the financial statements of a not-for-profit organization or a business enterprise that receives financial assistance from a governmental entity, the auditor should apply the guidance in paragraphs .11 through .15 that is relevant to that audit.

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<sup>9</sup> For purposes of this section, financial assistance, as defined by the Single Audit Act and OMB Circular A-128, does not include contracts to provide goods or services to a governmental entity or arrangements in which a nongovernmental entity purchases insurance from the government. Federal awards, as defined by OMB Circular A-133, means financial assistance and federal cost-type contracts used to buy services or goods for the use of the federal government. Federal awards does not include procurement contracts to vendors under grants or contracts used to buy goods or services. For example, financial assistance does not include a contract to design and manufacture aircraft for the U.S. Air Force or the purchase of deposit insurance by a financial institution. In addition, although Medicaid funds paid by the federal government to states are financial assistance, most Medicaid arrangements between the states and health-care providers are contracts for services that are not considered to be financial assistance.



## Working-Paper Documentation

.18 The auditor should document procedures performed to evaluate compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with section 339, *Working Papers*. The auditor's understanding of the internal control structure as it pertains to compliance with such laws and regulations, as well as the related assessment of control risk, should be documented in accordance with section 319. (Page 4-6 of *Government Auditing Standards* includes additional working-paper requirements that the auditor should follow when engaged to perform an audit in accordance with those standards.)

## Written Representations From Management

.19 Section 333, *Client Representations*, requires the auditor to obtain written representations from management as part of an audit conducted in accordance with generally accepted auditing standards. Among the matters ordinarily included in those representations are "violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency." In audits to which this section applies, auditors should consider obtaining additional representations from management acknowledging that—

- a. Management is responsible for the entity's compliance with laws and regulations applicable to it.
- b. Management has identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts.

## Reporting Under Government Auditing Standards

.20 A governmental entity, not-for-profit organization, or business enterprise may engage an auditor to audit its financial statements in accordance with *Government Auditing Standards*. In performing an audit in accordance with *Government Auditing Standards*, the auditor assumes responsibilities beyond those assumed in an audit conducted in accordance with generally accepted auditing standards to report on compliance with laws and regulations and on the internal control structure.<sup>10</sup>

## Reporting on Compliance With Applicable Laws and Regulations

.21 Paragraph 5 on page 5-2 of *Government Auditing Standards* includes the following requirement to report on compliance with laws and regulations:

The auditors should prepare a written report on their tests of compliance with applicable laws and regulations. This report, which may be included in either the report on the financial audit or a separate report, should contain a statement of positive assurance on those items which were tested for compliance and negative assurance on those items not tested. It should include all material instances of noncompliance, and all instances or indications of illegal acts which could result in criminal prosecution.

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<sup>10</sup> Concerning audit follow-up, paragraph 41 on page 3-16 of *Government Auditing Standards* states, "Due professional care also includes follow-up on known findings and recommendations from previous audits that could have an effect on the current audit objectives to determine whether prompt and appropriate corrective actions have been taken by entity officials or other appropriate organizations. . . . The auditor's report should disclose the status of known but uncorrected significant or material findings and recommendations from prior audits that [a]ffect the current audit objective."

.22 The auditor's report on compliance is based on the results of procedures performed as part of the audit of financial statements. Tests of compliance are discussed in paragraph .23 of this section. This section also discusses matters the auditor considers in reporting on compliance in accordance with *Government Auditing Standards*, as indicated below:

- a. Positive and negative assurance (paragraphs .24 through .26)
- b. Reporting noncompliance (paragraphs .27 through .30)
- c. Illegal acts (paragraphs .31 and .32)

#### Tests of Compliance With Applicable Laws and Regulations

.23 Paragraph 6 on page 4-2 of *Government Auditing Standards* includes a requirement that "a test should be made of compliance with applicable laws and regulations." The auditor will have complied with the requirements of *Government Auditing Standards* by designing the audit to provide reasonable assurance of detecting errors, irregularities, and illegal acts resulting from violations of laws and regulations that have a direct effect on the determination of financial statement amounts that are material to the financial statements, as required by sections 316 and 317.

#### Positive and Negative Assurance

.24 Paragraph 6 on page 5-2 of *Government Auditing Standards* states: "positive assurance consists of a statement by the auditors that the tested items were in compliance with applicable laws and regulations. Negative assurance is a statement that nothing came to the auditors' attention as a result of specified procedures that caused them to believe the untested items were not in compliance with applicable laws and regulations." The basic elements of a report expressing positive and negative assurance on compliance are—

- a. A statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with generally accepted auditing standards and with *Government Auditing Standards* issued by the Comptroller General of the United States.
- c. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- d. A statement that management is responsible for compliance with laws, regulations, contracts, and grants.
- e. A statement that, as part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, the auditor performed tests of compliance with certain provisions of laws, regulations, contracts, and grants.
- f. A statement that the objective of the audit of the financial statements was not to provide an opinion on overall compliance with such provisions and a disclaimer of opinion on compliance with laws, regulations, contracts, and grants.
- g. A statement of positive assurance that the results of the tests indicate that, with respect to the items tested, the entity complied,

in all material respects, with the provisions of laws, regulations, contracts, and grants referred to in item e.

- h. A statement of negative assurance that, with respect to items not tested, nothing came to the auditor's attention that caused him or her to believe that the entity had not complied, in all material respects, with the provisions of laws, regulations, contracts, and grants referred to in item e.<sup>11</sup>
- i. If applicable, a statement that certain immaterial instances of noncompliance were communicated to management in a separate letter.
- j. A statement that the report is intended for the information of the audit committee, management, and specific legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.<sup>12</sup>
- k. The manual or printed signature of the auditor's firm.
- l. The date of the auditor's report.

.25 The following is an example of an auditor's report on compliance when the auditor's procedures disclosed no material instances of noncompliance.

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [name of entity] is the responsibility of [name of entity]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [name of entity]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests indicate that, with respect to the items tested, [name of entity] complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those provisions.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. However, this report is a matter of public record and its distribution is not limited.<sup>13</sup>

[Signature]

[Date]

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<sup>11</sup> In the event that instances of noncompliance are reported as a result of tests performed, the auditor should consider the extent to which the pervasiveness of reported instances of noncompliance may affect the auditor's ability to express negative assurance with respect to items not tested.

<sup>12</sup> *Government Auditing Standards* permits the auditor to combine the report on compliance with the report on the financial statements; if the auditor does so, the combined report should include a statement about its intended use.

<sup>13</sup> If the report is not part of the public record, this sentence should not be included in the report.

.26 In rare circumstances, based on assessments of materiality and audit risk, auditors may decide not to perform any tests of compliance with provisions of laws, regulations, contracts, and grants. For example, an auditor may conclude that transactions and balances directly affected by laws and regulations are not material to the financial statements taken as a whole.<sup>14</sup> In such circumstances, *Government Auditing Standards*, in paragraph 6 on page 5-2, states that “. . . the report should contain a statement that the auditor did not test for compliance with laws and regulations.” The auditor’s report should not include a statement of positive assurance; however, the assessments of materiality and audit risk provide a basis for the auditor to conclude that the likelihood of material instances of noncompliance is low. These assessments are based, in part, on the procedures and considerations presented in paragraphs .11 through .15 of this section. Thus, the auditor has a basis for expressing negative assurance about compliance under *Government Auditing Standards*. The following is an illustration of the auditor’s report on compliance when, based on assessments of materiality and audit risk, the auditor concluded that it was not necessary to perform tests of compliance with laws and regulations.

*[First two paragraphs are the same as in the report illustrated in paragraph .25.]*

Compliance with laws, regulations, contracts, and grants applicable to [name of entity] is the responsibility of [name of entity]’s management. As part of our audit, we assessed the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants could cause the financial statements to be materially misstated. We concluded that the risk of such material misstatement was sufficiently low that it was not necessary to perform tests of [name of entity]’s compliance with such provisions of laws, regulations, contracts, and grants.

However, in connection with our audit, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with the laws, regulations, contracts, and grants referred to in the preceding paragraph.

*[Fifth paragraph, signature, and date are the same as in the report illustrated in paragraph .25.]*

### Reporting Noncompliance

.27 For purposes of this section, *material instances of noncompliance* are defined as failures to follow requirements, or violations of prohibitions, contained in statutes, regulations, contracts, or grants that cause the auditor to conclude that the aggregation of misstatements (that is, the auditor’s best estimate of the total misstatement) resulting from those failures or violations is material to the financial statements. When the auditor’s procedures disclose material instances of noncompliance, the auditor should modify the statements of positive and negative assurance included in the report. A qualified report should include—<sup>15</sup>

- a. The definition of material instances of noncompliance.
- b. An identification of material instances of noncompliance noted.<sup>16</sup>

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<sup>14</sup> See footnote 4.

<sup>15</sup> The auditor is not precluded from issuing an adverse report on compliance.

<sup>16</sup> Pages 5-3 and 5-4 of *Government Auditing Standards* provide the following guidance on reporting material instances of noncompliance: “[T]he auditors should place their findings in proper perspective. The extent of noncompliance should be related to the number of cases examined to give the reader a basis for judging the prevalence of noncompliance. . . . In presenting the findings, the auditor should follow the report contents standards, as appropriate, for objectives, scope and methodology, audit results, and views of responsible officials, and the report presentation standards, discussed in chapter 7 [of *Government Auditing Standards*].”

- c. A statement that the noncompliance noted was considered in forming an opinion on whether the entity's financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

.28 The auditor should report material instances of noncompliance regardless of whether the resulting misstatements have been corrected in the entity's financial statements. The auditor may wish to include a statement about whether the misstatements resulting from the material instances of noncompliance have been corrected in the financial statements or a statement describing the effect of such misstatements on his or her report on the basic financial statements. The following is an illustration of the auditor's report on compliance when material instances of noncompliance are identified.

*[First three paragraphs are the same as in the report illustrated in paragraph .25.]*

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in statutes, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in [name of entity]'s 19X1 financial statements.

*[Include paragraphs describing the material instances of noncompliance noted.]*

We considered these material instances of noncompliance in forming our opinion on whether [name of entity's] 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated [date of report] on those financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [name of entity] complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those provisions.<sup>17</sup>

*[Last paragraph, signature, and date are the same as those illustrated in paragraph .25.]*

.29 Page 5-3 of *Government Auditing Standards* includes the following provisions for reporting immaterial instances of noncompliance:

Other nonmaterial instances of noncompliance need not be disclosed in the compliance report but should be reported in a separate communication to the audited entity, preferably in writing. Such instances of noncompliance when communicated in a management letter to top management should be referred to in the report on compliance. All communications should be documented in the working papers.

.30 If the auditor has issued a separate letter describing immaterial instances of noncompliance, the report prepared in accordance with paragraphs .24, .26, or .27 of this section should be modified to include a statement such as the following: "We noted certain immaterial instances of noncompliance that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1."

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<sup>17</sup> See footnote 11.

### Illegal Acts

.31 As noted in paragraph .21, *Government Auditing Standards* requires the auditor to report instances or indications of illegal acts that could result in criminal prosecution. However, the auditor ordinarily does not possess the expertise to form a conclusion about whether an illegal act or possible illegal act could result in criminal prosecution. Thus, in complying with this requirement to report instances or indications of illegal acts that could result in criminal prosecution, the auditor may choose to report all illegal acts or possible illegal acts noted. (See paragraph 15, pages 4-4 and 4-5, of *Government Auditing Standards*, regarding consultation with legal counsel.)

.32 Paragraphs 13 and 16 in chapter 5 of *Government Auditing Standards* provide the following guidance on reporting illegal acts:

Public accountants conducting audits of government entities will discharge their responsibilities for reporting illegal acts or indications of such acts found during or in connection with an audit by promptly reporting to the top official of the entity arranging for the audit (including audit committees or others with equivalent authority). The auditor should also consider reporting to the appropriate oversight body. If the audited entity and the top official [are] believed to be [parties] to such acts or otherwise implicated, the auditor should in all cases report to the appropriate oversight body. Also, when the illegal acts involve funds received from other government entities, the audited entity should report to the proper officials, including those at the audit organization, of those entities. If the audited entity does not do so within a reasonable time or was unable to because the top official was involved, the auditor should report to the officials of those other government entities.

Illegal acts or indications of such acts that auditors become aware of need not be included in the required audit reports, but may be covered in a separate written report and submitted in accordance with the preceding paragraphs, thus permitting the required report or reports to be released. However, auditors generally should not release information or reports containing information on such acts or reports with references that such acts were omitted from reports, without consulting with appropriate legal counsel, since this release could interfere with legal processes, subject the implicated individuals to undue publicity, or subject the auditor to potential legal action.

### Reporting on the Internal Control Structure

.33 Consistent with section 325, the auditor should communicate any reportable conditions noted during the audit; however, reporting on the internal control structure under *Government Auditing Standards* differs from reporting under section 325.<sup>18</sup> *Government Auditing Standards* requires a written report on the internal control structure in all audits; section 325 requires communication—oral or written—only when the auditor has noted reportable conditions. *Government Auditing Standards* requires a description of any reportable conditions noted, including identification of those that are considered to be material weaknesses. Section 325 permits, but does not require, the auditor to separately identify and communicate as material weaknesses those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses. Finally, *Government Auditing Standards* requires communication of the following matters, which are not addressed by section 325:

- a. Identification of the categories of the internal control structure

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<sup>18</sup> *Government Auditing Standards* states on page 5-6 that the requirement for a report "does not require any additional audit work other than that required as part of a financial audit. . . ."

- b. Description of the scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing control risk
- c. Description of deficiencies in the internal control structure not considered significant enough to be reportable conditions

.34 Paragraphs .35 and .36 of this section provide guidance on identifying elements of the internal control structure in the auditor's report, and paragraph .37 addresses reporting the scope of the auditor's work. Paragraphs .38 and .39 address the communication of "nonreportable conditions." Paragraphs .41 and .42 illustrate reports on the internal control structure.

### Identifying Controls

.35 Paragraph 17 on page 5-6 of *Government Auditing Standards* requires that the auditor's report on internal control structure related matters describe "... the entity's significant internal controls or control structure including the controls established to ensure compliance with laws and regulations that have a material impact on the financial statements. ...". *Government Auditing Standards* presents examples of different ways in which the internal control structure might be classified, noting that auditors may modify these examples or use other classifications as appropriate for the particular circumstances on which they are reporting.

.36 Several variations are possible in the classifications presented in *Government Auditing Standards*. An entity might classify its transactions into a smaller or a larger number of classifications than mentioned in *Government Auditing Standards*. For example, the treasury or financing cycle might be classified as separate investments and debt cycles. For federal agencies, departments, and programs, the purchases/disbursements cycle might be subdivided into, among others, grants, loans, entitlements, payroll, and property and equipment; the revenue/receipts cycle might include taxes, duties, fines and licenses, sales of goods and services, and cash receipts. An entity might make its classifications on an entity-wide basis or on a departmental basis at the local operating units.

### Scope of the Auditor's Work

.37 *Government Auditing Standards* requires that the auditor's report on internal control structure related matters describe the scope of his or her work in obtaining an understanding of the internal control structure and in assessing control risk. Auditors may satisfy this requirement by stating (a) that they obtained an understanding of relevant internal control structure policies and procedures and whether those policies and procedures have been placed in operation and (b) that they assessed control risk.

### "Nonreportable Conditions"

.38 Paragraph 25 on page 5-10 of *Government Auditing Standards* states:

Nonreportable conditions in an audited entity's internal control structure not included in the required reports, should be separately communicated to the audited entity, preferably in writing. Such control structure conditions when communicated in a management letter to top management should be referred to in the report on internal controls. All communications should be documented in the working papers.

.39 To comply with this requirement, auditors should communicate to management the deficiencies in the internal control structure coming to their attention that they believe are not significant enough to be reportable conditions as defined in section 325. If the auditor has issued a separate written communication describing such "nonreportable conditions," the report pre-

pared in accordance with paragraph .40 of this section should be modified to include a statement such as the following: "However, we noted other matters involving the internal control structure and its operation that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1."

#### Contents of Reports on the Internal Control Structure

.40 When the auditor has noted reportable conditions in a financial statement audit conducted in accordance with *Government Auditing Standards*, the auditor's report on the internal control structure should contain—

- a. A statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with generally accepted auditing standards and with *Government Auditing Standards* issued by the Comptroller General of the United States.
- c. A statement that, in planning and performing the audit of the financial statements, the auditor considered the entity's internal control structure in order to determine the auditing procedures for purposes of expressing an opinion on the financial statements and not to provide assurance on the internal control structure.
- d. A statement that the establishment and maintenance of the internal control structure are the responsibilities of management.
- e. An explanation of the broad objectives and inherent limitations of any internal control structure.
- f. A description of the entity's significant internal control structure policies and procedures, considered as part of the auditor's understanding of the structure.
- g. A description of the scope of the auditor's work, stating that the auditor obtained an understanding of the design of relevant policies and procedures, determined whether those policies and procedures have been placed in operation, and assessed control risk.
- h. The definition of reportable conditions.
- i. A description of the reportable conditions noted.
- j. The definition of material weakness.
- k. A statement about whether the auditor believes any of the reportable conditions described in the report are material weaknesses, and if they are, identifies the material weaknesses noted.
- l. If applicable, a statement that other matters involving the internal control structure and its operation were communicated to management in a separate letter.
- m. A statement that the report is intended for the information of the audit committee, management, and specific legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.

.41 An example of such a report follows.

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.



We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of *[name of entity]* for the year ended June 30, 19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of *[name of entity]* is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories *[identify internal control structure categories]*.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

*[Include paragraphs to describe the reportable conditions noted.]*

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of *[name of entity]* in a separate letter dated August 15, 19X1.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. However, this report is a matter of public record and its distribution is not limited.<sup>19</sup>

[Signature]

[Date]

.42 Section 325.17 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. When the auditor notes no reportable conditions during an audit, he or she may issue a report, such as the following, to satisfy the requirements of *Government Auditing Standards*.

*[First through sixth paragraphs of the report are the same as those illustrated in paragraph .41.]*

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1.

*[Last paragraph, signature, and date are the same as those illustrated in paragraph .41.]*

## Responsibilities Under the Single Audit Act

.43 The Single Audit Act and OMB Circular A-128, "Audits of State and Local Governments," which the Office of Management and Budget (OMB) issued to prescribe policies, procedures, and guidelines to implement the act, require state and local governments that receive total federal financial assistance equal to or in excess of \$100,000 in a fiscal year to have an audit performed in accordance with the Single Audit Act. The Single Audit Act states that a state or local government receiving at least \$25,000, but less than \$100,000, of total federal financial assistance in a year has the option of having an audit performed in accordance with either the act or with federal laws and regulations governing the programs in which the government participates. The Single Audit Act does not require state or local governments receiving less than \$25,000 in total federal financial assistance to have an audit performed.<sup>20</sup>

.44 The auditor should test and report on the following matters pertaining to compliance with laws and regulations:

- a. Compliance with laws and regulations that may have a material effect on the financial statements (see paragraphs .21 through .32 of this section)

<sup>19</sup> See footnote 13.

<sup>20</sup> Auditors of colleges and other not-for-profit organizations that are not required to follow OMB Circular A-128 should follow OMB Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions," which is patterned after Circular A-128. See paragraphs .93 through .95.

- b. Compliance with general requirements applicable to federal financial assistance (paragraphs .46 through .52 address the general requirements)
- c. Compliance with specific requirements that may have a material effect on each major program, as defined by the Single Audit Act (paragraphs .53 through .86 address the specific requirements)
- d. Compliance with certain laws and regulations applicable to nonmajor federal financial assistance programs (see paragraphs .87 through .90)

.45 Among the other audit reports required by the Single Audit Act and OMB Circular A-128 are reports on the financial statements,<sup>21</sup> on the supplementary schedule of federal financial assistance, and on internal control structure policies and procedures relevant to federal financial assistance programs.<sup>22</sup> This section discusses the relationship between the work auditors do to form a basis for issuing those reports and the work auditors do to support their reports on compliance.

### Compliance Auditing—General Requirements

.46 The OMB's *Compliance Supplement for Single Audits of State and Local Governments*, which provides guidance for implementation of OMB Circular A-128, identifies nine "general requirements" that "involve significant national policy and for which failure to comply could have a material impact on an organization's financial statements including those prepared for federal programs. Accordingly, these compliance requirements shall be included as part of every audit of state, local, and Tribal government that involves [f]ederal financial assistance whether or not the government has a major program." The general requirements may or may not be laws and regulations that have a direct and material effect on the determination of financial statement amounts. Thus, the auditor should evaluate each general requirement based on the circumstances of the engagement to determine whether a particular requirement relates more to the laws and regulations described in section 317 that have an indirect effect on the financial statements than to those that have a direct and material effect on the determination of financial statement amounts.

.47 These general requirements deal with the following matters:<sup>23</sup>

- a. *Political activity*—prohibits the use of federal funds for partisan political activity
- b. *Davis-Bacon Act*—requires that laborers working on federally financed construction projects be paid a wage not less than the prevailing regional wage established by the Secretary of Labor

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<sup>21</sup> If, after the date of the report on the audited financial statements, (a) the auditor performs other procedures as part of a single audit and (b) the results of those procedures indicate that facts may have existed at the date of the report on the audited financial statements that might have affected that report had the auditor then been aware of such facts, the auditor should follow section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

<sup>22</sup> Paragraph .102 to this section summarizes the procedures performed and reports issued in an audit in accordance with the Single Audit Act of 1984 and OMB Circular A-128 or OMB Circular A-133.

<sup>23</sup> Besides describing the general requirements, the *Compliance Supplement* includes references to the *Code of Federal Regulations* or other statutes where additional information about the requirements can be obtained. The auditor should consider referring to this information when planning to test compliance with the general requirements. The *Compliance Supplement* is revised periodically and, thus, the number of general requirements may change.

- c. *Civil rights*—prohibits violation of anyone's civil rights in a program funded by the federal government
- d. *Cash management*—requires recipients of federal financial assistance to minimize the time lapsed between receipt and disbursement of that assistance
- e. *Relocation assistance and real property acquisition*—prescribes how real property should be acquired with federal financial assistance and how recipients must help relocate people displaced when property is acquired
- f. *Federal financial reports*—prescribes federal financial reports that must be filed
- g. *Allowable costs/cost principles*—prescribes the direct and indirect costs allowable for federal reimbursement
- h. *Drug-free workplace*—prescribes that grantees must certify that they provide a drug-free workplace
- i. *Administrative requirements*—prescribes administrative requirements (in addition to d, f, and g) that should be followed (Common Rule)

.48 The *Compliance Supplement* suggests procedures for testing compliance with the general requirements. As the Single Audit Act and OMB Circular A-128 have been implemented, it has become generally accepted that the nature of these procedures is sufficient to satisfy the requirements of the act with respect to the general requirements. However, the *Compliance Supplement* does not specify the extent of such procedures. The auditor should exercise professional judgment in determining the extent of procedures for testing compliance with the general requirements, and may wish to obtain an understanding with the client about the extent of such procedures.

.49 In performing an audit under the Single Audit Act and OMB Circular A-128, the auditor should issue a report on compliance with general requirements regardless of whether or not the government being audited has major programs. Determining the extent of any tests of compliance with the general requirements is a matter of professional judgment. Among the matters the auditor considers are the extent of any tests of controls over compliance with general requirements performed for major programs. If the government being audited has no major programs, the auditor should consider whether his or her tests of controls over compliance with general requirements provide evidence that would also support a report on compliance. If the tests of controls do not provide sufficient evidence to support a report on compliance, additional testing on the general requirements would need to be performed.<sup>24</sup>

.50 This section does not require the auditor to issue an opinion on compliance with the general requirements; rather, the auditor issues a report on the results of procedures used to test compliance with the general requirements.

.51 The basic elements of a report expressing positive and negative assurance on compliance with the general requirements include—

- a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial

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<sup>24</sup> Further guidance is provided in Statement of Position 90-9, *The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act*.

- statements, including a description of any departure from the standard report
- b. A statement identifying the general requirements tested
  - c. A statement that the auditor's procedures were limited to the applicable procedures described in the *Compliance Supplement* or that describes alternative procedures
  - d. A statement that the auditor's procedures were substantially less in scope than an audit and a disclaimer of an opinion on compliance with the general requirements
  - e. A statement of positive assurance that, with respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the general requirements
  - f. A statement of negative assurance that, with respect to items not tested, nothing came to the auditor's attention that caused him or her to believe that the entity had not complied, in all material respects, with the general requirements<sup>25</sup>
  - g. A summary of all instances of noncompliance noted and identification of amounts questioned or reference to a separate schedule of findings and questioned costs (see paragraphs .77 through .79 of this section)
  - h. A statement that the report is intended for the information of the audit committee, management, and specified legislative or regulatory bodies but that this is not intended to limit the distribution of the report, if it is a matter of public record
  - i. The manual or printed signature of the auditor's firm
  - j. The date of the auditor's report

.52 The following is an example of a report on compliance with the general requirements.

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We have applied procedures to test [name of entity]'s compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the schedule of federal financial assistance, for the year ended June 30, 19X1. [List the general requirements tested.]

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Single Audits of State and Local Governments* [or describe alternative procedures performed]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [name of entity]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.<sup>26</sup>

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<sup>25</sup> See footnote 11.

<sup>26</sup> If there are no instances of noncompliance, this sentence should be omitted.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. However, this report is a matter of public record and its distribution is not limited.<sup>27</sup>

[Signature]

[Date]

### Compliance Auditing—Specific Requirements—Major Programs

.53 The Single Audit Act states that the auditor “shall determine and report whether the government, department, agency, or establishment has complied with laws and regulations that may have a material effect upon each major federal assistance program.”<sup>28</sup> This section establishes that, to comply with this requirement, the auditor should perform auditing procedures designed to provide reasonable assurance of detecting material noncompliance with “specific requirements” applicable to major federal financial assistance programs and issue a report containing either an opinion on compliance with those requirements or a statement that such an opinion cannot be expressed (see paragraphs .55 through .86).

.54 Auditors should consider the following matters in auditing and reporting on specific requirements:

- a. Identifying major federal financial assistance programs (paragraphs .55 and .56)
- b. Materiality in a compliance audit of major federal financial assistance programs (paragraph .57)
- c. Specific requirements applicable to a major federal financial assistance program (paragraphs .58 through .62)
- d. Components of the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance (paragraphs .63 through .73)
- e. Subrecipient considerations (paragraphs .74 and .75)
- f. Evaluating results of audit procedures (paragraphs .76 through .79)
- g. Reporting on compliance with specific requirements (paragraphs .80 through .86)
- h. Management representations (paragraphs .91 and .92)

#### Identification of Major Federal Financial Assistance Programs

.55 Management's responsibility for identifying federal financial assistance programs is established in the following requirement of OMB Circular A-128:

In order to determine which major programs are to be tested for compliance, [s]tate and local governments shall identify in their accounts all [f]ederal funds received and expended and the programs under which they were received. This shall include funds received directly from [f]ederal agencies and through other [s]tate and local governments.

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<sup>27</sup> See footnote 13.

<sup>28</sup> A major federal financial assistance program is defined in terms of a government's expenditure of federal financial assistance under that program relative to its total expenditures of federal financial assistance. (See the Glossary to this section [paragraph .104] for the definition of major federal financial assistance program.) OMB has published *Questions and Answers on the Single Audit Provisions of OMB Circular A-128, "Audits of State and Local Governments,"* which addresses such matters as the determination of whether federal assistance involving no expenditures, such as loan guarantees, constitutes a major program.

.56 The preparation of the schedule of federal financial assistance, required by OMB Circular A-128, is a means by which management identifies major and nonmajor federal financial assistance programs. In assessing the appropriateness of this identification, the auditor should consider, among other matters, evidence obtained from audit procedures performed in the audit of the financial statements, such as procedures performed to evaluate the completeness and classification of recorded revenues and expenditures.

#### **Materiality**

.57 In auditing compliance with requirements governing major federal financial assistance programs in accordance with the Single Audit Act and OMB Circular A-128, the auditor's consideration of materiality differs from that in an audit of financial statements in accordance with generally accepted auditing standards. In an audit of an entity's financial statements conducted in accordance with generally accepted auditing standards, the auditor considers materiality in relation to the financial statements.<sup>29</sup> In auditing an entity's compliance with requirements governing each major federal financial assistance program in accordance with the Single Audit Act and OMB Circular A-128, however, the auditor considers materiality in relation to each such program. When reaching a conclusion as to whether the effect of noncompliance, individually or in the aggregate, is material to a major federal financial assistance program, an auditor ordinarily should consider the nature of the noncompliance and the amount affected by it in relation to the nature and amount of the major federal financial assistance program under audit. For example, an amount that is material to one major federal financial assistance program may not be material to a major federal financial assistance program of a different size or nature. Also, what is material to a particular major federal financial assistance program might change from one period to another.

#### **Identification of Specific Requirements Applicable to Major Programs**

.58 In performing an audit in accordance with the Single Audit Act and OMB Circular A-128, the auditor should test compliance with the specific requirements, as described below, that are applicable to major federal financial assistance programs. The auditor should obtain an understanding of those requirements that is sufficient to enable him or her to determine the nature, timing, and extent of procedures he or she will perform to provide a basis for expressing an opinion on compliance.<sup>30</sup> Specific requirements that, if not complied with, could have a material effect on a major federal financial assistance program generally pertain to the following matters:<sup>31</sup>

- a. *Types of services allowed or not allowed*, which specifies the types of goods or services entities may purchase with financial assistance
- b. *Eligibility*, which specifies the characteristics of individuals or groups to which entities may give financial assistance
- c. *Matching, level of effort, or earmarking*, which specifies amounts entities should contribute from their own resources toward projects for which financial assistance is provided

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<sup>29</sup> See footnote 4.

<sup>30</sup> The auditor would be precluded from issuing an opinion on compliance with a specific requirement if he or she concluded that management's assertion about compliance with that requirement is not capable of reasonably consistent estimation or measurement.

<sup>31</sup> Certain of these requirements may have a direct and material effect on the determination of financial statement amounts. Thus, the auditor may wish to integrate his or her compliance audit of major federal financial assistance programs with work performed in the audit of the financial statements.

- d. *Reporting*, which specifies reports entities must file in addition to those required by the general requirements
- e. *Special tests and provisions*, other provisions for which federal agencies have determined noncompliance could materially affect the program (for example, some programs require recipients to hold public hearings on the proposed use of federal financial assistance; others set a deadline for the expenditure of federal financial assistance)

.59 Additionally, OMB Circular A-128 requires independent auditors to determine whether—

- [f]ederal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the basic financial statements have been prepared, and
- amounts claimed or used for matching were determined in accordance with OMB Circular A-87, “Cost Principles for State and Local Governments,” and OMB Circular A-102, “Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments.”

.60 OMB Circular A-128 requires that the auditor’s report on compliance specifically address the requirements presented in paragraph .59.

.61 The *Compliance Supplement* was issued by the Office of Management and Budget to assist auditors in performing single audits and supplements OMB Circular A-128. It describes compliance requirements specific to many of the larger federal financial assistance programs and suggests procedures for testing compliance with the specific requirements.<sup>32</sup> Besides describing these specific requirements, the *Compliance Supplement* includes references to the *Code of Federal Regulations* and other sources of information about the requirements. The auditor should consider referring to these other sources of information in planning to test compliance with specific requirements. The auditor should also be aware that compliance requirements may change over time.

.62 Major federal government programs not included in the *Compliance Supplement* may prescribe specific requirements governing financial assistance. To obtain an understanding of the specific requirements of the major programs not included in the *Compliance Supplement*, the auditor should consider reviewing the *Catalog of Federal Domestic Assistance* (hereafter referred to as the *Catalog of Assistance*). That publication, generally updated on an annual basis, contains all federal financial assistance programs, with citations to applicable laws and regulations associated with those programs. Also, the *Catalog of Assistance* contains names of program staff who serve as reference individuals for each program. The auditor may also wish to consider certain procedures described in paragraph .11 of this section that may be relevant to major programs.

#### **Components of Audit Risk in a Compliance Audit of Major Programs**

.63 Audit risk—the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance—is composed of inherent

<sup>32</sup> In its *Questions and Answers on the Single Audit Provisions of OMB Circular A-128, “Audits of State and Local Governments,”* the OMB states that, for the programs contained in the *Compliance Supplement*, the audit of the requirements contained in the supplement will meet the requirements of OMB Circular A-128.



risk, control risk, and detection risk. For purposes of a compliance audit of major federal financial assistance programs, these components are defined as follows:

- a. **Inherent risk**—The risk that material noncompliance with requirements applicable to a major federal financial assistance program could occur, assuming there are no related internal control structure policies or procedures
- b. **Control risk**—The risk that material noncompliance that could occur in a major federal financial assistance program will not be prevented or detected on a timely basis by the entity's internal control structure policies and procedures
- c. **Detection risk**—The risk that an auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major federal financial assistance program does not exist when in fact such noncompliance does exist.

.64 When considered together, the Single Audit Act and OMB Circular A-128 require the auditor to perform procedures that assess inherent and control risk and that restrict detection risk. The following paragraphs discuss the provisions of the Single Audit Act and OMB Circular A-128 that pertain to each of these components of risk, provide guidance on applying those provisions, and explain how the components of risk interrelate in providing a basis for the auditor's opinion on compliance.

**.65 Inherent risk.** Paragraph 8 of OMB Circular A-128 includes the following guidance, related to inherent risk, on determining the nature and extent of testing compliance with requirements that, if not complied with, could have a material effect on a major federal financial assistance program.

The selection and testing of transactions shall be based on the auditor's professional judgment considering such factors as the amount of expenditures for the program and the individual awards; the newness of the program or changes in its conditions; prior experience with the program, particularly as revealed in audits and other evaluations (e.g., inspections, program reviews); the extent to which the program is carried out through subrecipients; the extent to which the program contracts for goods or services; . . . the expectation of adherence or lack of adherence to the applicable laws and regulations; and the potential impact of adverse findings.

.66 In assessing inherent risk, the auditor may also consider the results of any procedures performed as part of the audit of the financial statements, and of any tests of compliance with the general requirements.

**.67 Control risk.** The Single Audit Act requires the auditor to determine and report whether the entity has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. Paragraph 8(a) of OMB Circular A-128 expands on this requirement.

The auditor must make a study and evaluation of internal control systems used in administering [f]ederal assistance programs. The study and evaluation must be made whether or not the auditor intends to place reliance on such systems. As part of this review, the auditor shall:

- (1) Test whether these internal control systems are functioning in accordance with prescribed procedures.
- (2) Examine the recipient's system for monitoring subrecipients and obtaining and acting on subrecipient audit reports.

.68 These provisions of the Single Audit Act and OMB Circular A-128 encompass internal control structure policies and procedures relevant to an

audit of an entity's compliance with the specific requirements, discussed in paragraphs .58 through .62 of this section, applicable to major federal financial assistance programs.<sup>33</sup> Paragraphs .69 through .71 of this section discuss, in general terms, the auditor's consideration of these policies and procedures in an audit of compliance with requirements applicable to major federal financial assistance programs. Paragraphs .74 and .75 specifically address subrecipient considerations.

**.69** In satisfying the internal control provisions of the Single Audit Act and OMB Circular A-128, the auditor should obtain an understanding of the design of relevant internal control structure policies and procedures and whether they have been placed in operation. This understanding should be sufficient to plan the audit of compliance, enabling the auditor to—

- a. Identify the types of potential material noncompliance.
- b. Consider matters that affect the risk of material noncompliance.
- c. Design effective tests of compliance with requirements applicable to major federal financial assistance programs.

**.70** OMB Circular A-128's requirement to "test whether these internal control systems are functioning in accordance with prescribed procedures" involves performing tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance. Procedures performed to obtain an understanding of the internal control structure may be considered tests of controls if they provide evidential matter about the effectiveness of the design and operation.

**.71** After obtaining an understanding of the internal control structure policies and procedures, the auditor should assess control risk. Assessing control risk contributes to the auditor's evaluation of the risk that material noncompliance exists in a major federal financial assistance program. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such noncompliance may exist. The auditor uses this evidential matter as part of the reasonable basis for the opinion on compliance.

**.72 Detection risk.** OMB Circular A-128 states that a compliance audit of major federal financial assistance programs should "include the selection and testing of a representative number of charges from each major [f]ederal assistance program." Such compliance testing serves to restrict detection risk. In determining an acceptable level of detection risk, the auditor considers the level to which he or she seeks to restrict audit risk related to the major federal financial assistance program and the assessed levels of inherent risk and control risk. As the assessed level of control risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of compliance tests performed.

**.73** In determining the nature of his or her tests of compliance with requirements governing major federal financial assistance programs, the auditor should consider the nature of those requirements. For example, to test compliance with requirements applicable to the allowability of expenditures using program funds, audit procedures should be designed to provide the auditor with sufficient evidential matter to evaluate how management used

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<sup>33</sup> The application of these provisions of the Single Audit Act and OMB Circular A-128 may also encompass internal control structure policies and procedures relevant to compliance with other requirements, including those applicable to nonmajor programs. Guidance on the application of these provisions, including guidance on reporting, is presented in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and related AICPA statements of position.

the federal financial assistance. In designing compliance tests, auditors may wish to consider the procedures suggested in the *Compliance Supplement* for testing compliance with the requirements specific to many of the larger federal financial assistance programs.

#### **Subrecipient Considerations**

.74 Under the requirements of the Single Audit Act and OMB Circular A-128, when in a single fiscal year a primary recipient passes \$25,000 or more of federal financial assistance through to a subrecipient, the primary recipient is responsible for determining that the subrecipient expends that assistance in accordance with applicable laws and regulations. That is, the primary recipient should—

- a. Determine whether subrecipients have met the audit requirements of OMB Circular A-128 or OMB Circular A-133, whichever is applicable.
- b. Determine whether the subrecipient spent the federal financial assistance in accordance with applicable laws and regulations.
- c. Ensure that appropriate corrective action is taken within six months after receipt of a subrecipient's auditor's report that identifies noncompliance with federal laws and regulations.
- d. Consider whether the results of subrecipients' audits indicate that the primary recipient should adjust its own records.
- e. Require each subrecipient to permit independent auditors to have access to their records and financial statements as necessary to comply with OMB Circular A-128.

.75 OMB Circular A-128 requires the primary recipient's auditor to evaluate the primary recipient's system for monitoring subrecipients. Although the primary recipient's auditor may be engaged to audit the subrecipients, neither the Single Audit Act nor OMB Circular A-128 requires the auditor to perform such an audit as part of the audit of the primary recipient.

#### **Evaluating Results of Audit Procedures**

.76 In evaluating whether an entity has complied with laws and regulations that, if not complied with, could have a material effect on each major federal financial assistance program, the auditor should consider the effect of identified instances of noncompliance on each such program. In doing so, the auditor should consider—

- a. The frequency of noncompliance identified in the audit.
- b. The adequacy of a primary recipient's system for monitoring subrecipients and the possible effect on the program of any noncompliance identified by the primary recipient or the subrecipients' auditors.
- c. Whether any instances of noncompliance identified in the audit resulted in questioned costs, as discussed below, and if they did, whether questioned costs are material to the program.

.77 The criteria for classifying a cost as a questioned cost vary from one federal agency to another. Many of the criteria were established by Congress when it authorized the programs and provided the funds; others were established through agency regulations. Generally, the criteria relate to the following:

- a. Unallowable costs, or costs specifically not allowed under the general and special requirements or conditions of the program

- b. Undocumented costs, or costs charged to a program for which detailed documentation does not exist
- c. Unapproved costs, or costs for which the program requires approval and the auditor cannot find evidence of approval, or costs not provided for in an approved budget
- d. Unreasonable costs, or costs incurred that may not reflect the actions of a prudent person, or the assignment of an unreasonably high value to in-kind contributions.

.78 In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned for each major federal financial assistance program (hereafter referred to as *likely questioned costs*), not just the questioned costs specifically identified (hereafter referred to as *known questioned costs*). When using audit sampling, as defined in section 350, *Audit Sampling*, in testing compliance, the auditor projects the amount of known questioned costs identified in the sample to the items in the major federal financial assistance program from which the sample was selected.

.79 Regardless of the auditor's opinion on compliance, OMB Circular A-128 requires him or her to report any instances of noncompliance found and any resulting questioned costs. In reporting instances of noncompliance, the auditor should follow the provisions of paragraph 9 on page 5-3 of *Government Auditing Standards*. The auditor should relate the number of instances of noncompliance that resulted in known questioned costs to the number of transactions examined. For purposes of reporting questioned costs, neither the Single Audit Act nor OMB Circular A-128 requires the auditor to report likely questioned costs; rather, the auditor should report only known questioned costs.

#### **Reporting on Compliance With Specific Requirements—Major Programs**

.80 The basic elements of the auditor's report on compliance with specific requirements include—

- a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the entity's compliance with the requirements identified in the report was audited.
- c. A statement that compliance with the requirements in item *b*, is the responsibility of the entity's management and that the auditor's responsibility is to express an opinion on compliance with those requirements based on the audit.
- d. A statement that the audit was conducted in accordance with generally accepted auditing standards; *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-128, "Audits of State and Local Governments."
- e. A statement that generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Circular A-128 require that the auditor plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to in item *b* occurred.

- f. A statement that an audit includes examining, on a test basis, evidence about the entity's compliance with the requirements referred to in item *b*.
- g. A statement that the auditor believes that his or her audit provides a reasonable basis for an opinion.
- h. A summary of all instances of noncompliance noted and identification of amounts questioned or reference to a separate schedule of findings and questioned costs.
- i. A statement that noncompliance or questioned costs noted were considered in forming an opinion as to whether the entity complied, in all material respects, with requirements referred to in item *b*.
- j. An opinion as to whether the entity complied, in all material respects, with the requirements referred to in item *b*.
- k. A statement that the report is intended for the information of the audit committee, management, and specific legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.
- l. The manual or printed signature of the auditor's firm.
- m. The date of the auditor's report.

.81 The following is an example of an unqualified opinion of an entity's compliance with requirements that govern each major federal financial assistance program.

We have audited the financial statements of [*name of entity*] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We have also audited the [*name of entity*]'s compliance with the requirements governing [*list specific requirements tested—see paragraphs .58 and .59*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of [*name of entity*] is responsible for [*name of entity*]'s compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-128, "Audits of State and Local Governments." Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*name of entity*]'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.<sup>34</sup>

In our opinion, the [*name of entity*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

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<sup>34</sup> If there are no instances of noncompliance, this paragraph should be omitted.

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record and its distribution is not limited.<sup>35</sup>

*[Signature]*

*[Date]*

.82 Auditors are able to express an unqualified opinion only if they have been able to apply all the procedures they consider necessary in the circumstances. Restrictions on the scope of their audit, whether imposed by the client or by circumstances such as the timing of the auditors' work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require auditors to qualify their opinion or to disclaim an opinion. In such instances, the reasons for such a qualification or disclaimer of opinion should be described in the auditor's report. Further, the auditor should consider the effects of such instances on his or her ability to express an unqualified opinion on the financial statements.

.83 The auditor's decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on compliance with requirements governing each major federal financial assistance program. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to each major federal financial assistance program. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on compliance. The following is an example of an opinion qualified because of a scope limitation.

*[First and second paragraphs of the report are the same as those illustrated in paragraph .81.]*

Except as discussed in the following paragraph, we conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-128, "Audits of State and Local Governments." Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the *[name of entity]*'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain sufficient documentation supporting the *[name of entity]*'s compliance with the requirements of Major Program ABC governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to the *[name of entity]*'s compliance with those requirements of Major Program ABC by other auditing procedures.

*[Fifth paragraph of the report is the same as the fourth paragraph of the report illustrated in paragraph .81.]*

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding the *[name of entity]*'s compliance with the requirements of Major Program ABC governing types of services allowed or unallowed, the *[name of entity]* complied, in all material respects, with the requirements governing *[list requirements tested]* that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

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<sup>35</sup> See footnote 13.

*[Last paragraph of the report is the same as the sixth paragraph of the report illustrated in paragraph .81.]*

*[Signature ]*

*[Date ]*

**.84** When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph(s) the reasons why his or her audit did not comply with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, or OMB Circular A-128. The auditor should state that the scope of his or her audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed or include a paragraph describing the characteristics of an audit (that is, the scope paragraph); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any reservations he or she has regarding compliance with applicable laws and regulations. The following is an example of a report disclaiming an opinion resulting from an inability to obtain sufficient competent evidential matter because of a scope limitation.

*[First paragraph of the report is the same as the first paragraph of the report illustrated in paragraph .81.]*

We were engaged to audit *[name of entity]*'s compliance with the requirements governing *[list requirements to have been tested]* that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of *[name of entity]* is responsible for *[name of entity]*'s compliance with those requirements.

*[Third paragraph of the report illustrated in paragraph .81 should be omitted.]*

The management of *[name of entity]* has refused to provide us with written representations that generally accepted auditing standards require us to obtain.

Because of the matter described in the preceding paragraph, the scope of our audit work was not sufficient to enable us to express, and we do not express, an opinion on *[name of entity]*'s compliance with the requirements governing *[list requirements to have been tested]* that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

*[Last paragraph of the report is the same as the sixth paragraph of the report illustrated in paragraph .81.]*

*[Signature ]*

*[Date ]*

**.85** When the audit of an entity's compliance with requirements governing a major federal financial assistance program detects noncompliance with those requirements that the auditor believes have a material effect on that program, the auditor should express a qualified or adverse opinion. The auditor should state the basis for such an opinion in the report. The following is an example of an auditor's opinion that is qualified because of noncompliance with requirements governing federal financial assistance.

*[First three paragraphs of the report are the same as those illustrated in paragraph .81.]*

The results of our audit procedures for Major Program ABC disclosed that *[name of entity]* did not comply with the requirement that *[name of entity]* match the funds received from Major Program ABC. In our opinion, *[name of entity]*'s matching of funds received from Major Program ABC is necessary for *[name of entity]* to comply with the requirements applicable to Major Program ABC.

*[Fifth paragraph of the report is the same as the fourth paragraph of the report illustrated in paragraph .81.]*

In our opinion, except for those instances of noncompliance with the requirements applicable to Major Program ABC referred to in the fourth paragraph of this report and identified in the accompanying schedule of findings and questioned costs, [name of entity] complied, in all material respects, with the requirements governing [list requirements tested] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

*[Last paragraph of the report is the same as the sixth paragraph of the report illustrated in paragraph .81.]*

*[Signature]*

*[Date]*

**.86** Following is an example of an adverse opinion because of noncompliance with requirements governing federal financial assistance.

*[First three paragraphs of the report are the same as those illustrated in paragraph .81.]*

*[Add a paragraph describing reasons for the adverse opinion.]*

*[Fifth paragraph of the report is the same as the fourth paragraph of the report illustrated in paragraph .81.]*

In our opinion, because of the noncompliance referred to in the fourth paragraph, [name of entity] did not comply, in all material respects, with the requirements governing [list requirements tested] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

*[Last paragraph of the report is the same as the sixth paragraph of the report illustrated in paragraph .81.]*

*[Signature]*

*[Date]*

### **Compliance Auditing—Specific Requirements—Nonmajor Programs**

**.87** The Single Audit Act and OMB Circular A-128 require that “[t]ransactions selected from [f]ederal assistance programs, other than major [f]ederal assistance programs, . . . shall be tested for compliance with [f]ederal laws and regulations that apply to such transactions.” This requirement recognizes that, in connection with the audit of the financial statements or the consideration of the internal control structure over federal financial assistance programs, the auditor may have selected for testing transactions from federal financial assistance programs other than major programs. If the auditor has selected such transactions, they should be tested for compliance with the requirements that apply to the individual transactions.<sup>36</sup>

**.88** Generally, the requirements for which compliance should be tested relate to the allowability of the program expenditure and the eligibility of the individuals or groups to which the entity provides federal financial assistance. For example, if in the audit of the financial statements an auditor examines a payroll transaction that was charged to a nonmajor program, the auditor should determine whether the position could reasonably be charged to that program and whether the individual's salary was correctly charged to that program.

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<sup>36</sup> If the auditor has not selected any nonmajor federal financial assistance program transactions, or if the entity has no nonmajor programs, no report describing that situation is required.



.89 The basic elements of the auditor's report on compliance with requirements applicable to nonmajor federal financial assistance program transactions include—

- a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements including a description of any departure from the standard report.
- b. A statement identifying the requirements tested.
- c. A statement that the procedures for testing compliance with the specific requirements applicable to nonmajor federal financial assistance programs are required by OMB Circular A-128.
- d. A statement that these procedures were performed in connection with an audit of the financial statements and with the consideration of the internal control structure over federal financial assistance programs, as required by OMB Circular A-128.
- e. A statement that the auditor's procedures were substantially less in scope than an audit and a disclaimer of an opinion on compliance with the requirements identified.
- f. A statement of positive assurance that, with respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the specific requirements identified.<sup>37</sup>
- g. A statement of negative assurance that, with respect to items not tested, nothing came to the auditor's attention that caused him or her to believe that the entity had not complied, in all material respects, with the specific requirements identified.<sup>38</sup>
- h. A summary of all instances of noncompliance noted and identification of amounts questioned or reference to a separate schedule of findings and questioned costs.
- i. A statement that the report is intended for the information of the audit committee, management, and specified legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.
- j. The manual or printed signature of the auditor's firm.
- k. The date of the auditor's report.

.90 Following is an illustrative report on the results of the tests of compliance with the requirements applicable to nonmajor federal financial assistance program transactions. (When the auditor issues a report on compliance for major federal financial assistance programs, these reports may be combined.)

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

In connection with our audit of the financial statements of [name of entity] and with our consideration of [name of entity]'s internal control structure used to administer federal financial assistance programs, as required by Office of Management and Budget Circular A-128, "Audits of State and Local

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<sup>37</sup> For purposes of reporting on compliance with requirements applicable to nonmajor federal financial assistance programs, the auditor should consider material noncompliance to be the same as "material instances of noncompliance," which is defined in paragraph .27 of this section.

<sup>38</sup> See footnote 11.

Governments," we selected certain transactions applicable to certain nonmajor federal financial assistance programs for the year ended June 30, 19X1. As required by Circular A-128, we have performed auditing procedures to test compliance with the requirements governing [*list requirements tested*] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of entity*]'s compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of entity*] had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.<sup>39</sup>

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.<sup>40</sup>

[*Signature*]

[*Date*]

### Written Representations From Management

.91 The auditor should obtain written representations from management as part of an audit conducted in accordance with the Single Audit Act of 1984 and OMB Circular A-128. The following are specific written representations ordinarily obtained by the auditor:

- a. Management has identified in the schedule of federal financial assistance all assistance provided by federal agencies in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations.
- b. Management has identified the requirements governing political activity, the Davis-Bacon Act, civil rights, cash management, relocation assistance and real property management, federal financial reports, allowable costs/cost principles, drug-free workplace, and administrative requirements over federal financial assistance.
- c. Management has identified the requirements governing types of services allowed or disallowed; eligibility; matching, level of effort, or earmarking; reporting; [*include any special provisions*]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the schedule of federal financial assistance.
- d. Management has complied with reporting requirements in connection with federal financial assistance.
- e. Information presented in federal financial reports and claims for advances and reimbursements is supported by the books and records from which the basic financial statements have been prepared.
- f. Amounts claimed or used for matching were determined in accordance with OMB Circular A-87, "Cost Principles for State and Local Governments," and the OMB's "Uniform Administrative Require-

<sup>39</sup> If there are no instances of noncompliance, this sentence should be omitted.

<sup>40</sup> See footnote 13.

ments for Grants and Cooperative Agreements to State and Local Governments.”

- g. Management has monitored subrecipients to determine that the subrecipients expend financial assistance in accordance with applicable laws and regulations and have met the requirements of OMB Circular A-128 or OMB Circular A-133, whichever is applicable.
- h. Management has taken appropriate corrective action on a timely basis after receipt of a subrecipient’s auditor’s report that identifies noncompliance with federal laws and regulations.
- i. Management has considered the results of subrecipients’ audits and made any necessary adjustments to the entity’s own books and records.
- j. Management has identified and disclosed to the auditor all amounts questioned and known noncompliance with requirements that could have a material effect on a major federal financial assistance program.

.92 Management’s refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on compliance with the specific requirements.<sup>41</sup> Further, the auditor should consider the effects of management’s refusal on his or her ability to rely on other management representations.

## Responsibilities Under OMB Circular A-133

.93 OMB Circular A-133, “Audits of Institutions of Higher Education and Other Nonprofit Institutions,” prescribes audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards (either directly or indirectly). Circular A-133 states that nonprofit institutions receiving \$100,000 or more per year in federal awards are to have an audit in accordance with Circular A-133. (The definition of *federal award* is broader than the definition of *federal financial assistance*. See footnote 9.) Nonprofit institutions receiving \$100,000 or more but receiving awards under only one program have the option of having an audit performed in accordance with the provisions of Circular A-133 or having an audit made of the one program. Nonprofit institutions that receive at least \$25,000 but less than \$100,000 per year in federal awards have the option of having an audit performed in accordance with Circular A-133 or of having an audit made of each federal award. Nonprofit institutions receiving less than \$25,000 per year in federal awards are exempt from federal audit requirements, but records are to be available for review by appropriate officials of the federal grantor agency or subgranting entity.

.94 The auditor is to test and report on the matters pertaining to—

- a. Compliance with laws and regulations that may have a direct and material effect on the entity’s financial statement amounts.
- b. Compliance with the general requirements applicable to the federal award programs.
- c. Compliance with specific requirements that may have a direct and material effect on each major program, as defined in OMB Circular A-133. OMB Circular A-133 defines a major program as one in

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<sup>41</sup> See paragraph .84 of this section for an illustration of the auditor’s report on compliance with specific requirements when the auditor concludes that management’s refusal to provide written representations is cause for a disclaimer of opinion.

which federal expenditures total the larger of 3 percent of total federal funds expended or \$100,000. Each of the following categories of federal awards constitutes a major program: research and development; student financial aid; individual awards not in the student aid or research-and-development category. (Under the Single Audit Act and OMB Circular A-128, a major program is defined as one in which federal expenditures total the larger of 3 percent of total federal expenditures or \$300,000.)

- d. Compliance with certain laws and regulations applicable to nonmajor federal financial assistance programs.

.95 These reports are similar to those required by the Single Audit Act and OMB Circular A-128; therefore, the guidance in paragraphs .43 through .92 of this section is also generally applicable to audits in accordance with OMB Circular A-133. Among the other audit reports required by OMB Circular A-133 are reports on the financial statements, on the supplementary schedule of federal awards, and on the internal control structure policies and procedures relevant to federal awards. However, OMB Circular A-133, unlike OMB Circular A-128, does not require the auditor to include a description of immaterial noncompliance in the audit reports. However, immaterial noncompliance is required to be reported in a separate written communication to the institution, which management is required to submit to the appropriate federal grantor agencies or subgrantor sources.

## Other Compliance Auditing Responsibilities

### Program-Specific Audits

.96 Under certain circumstances, the Single Audit Act and OMB Circular A-128 and OMB Circular A-133 permit certain recipients of federal financial assistance to have a "program-specific" audit. Entities not covered by the Single Audit Act or OMB Circular A-133 may also engage an auditor to conduct a program-specific audit in accordance with a federal audit guide (such as the U.S. Department of Education's *Student Financial Aid Audit Guide* or the U.S. Department of Housing and Urban Development's *Consolidated Audit Guide for Audits of HUD Programs*) or in accordance with an agreement from the grantor agency. When engaged to conduct a program-specific audit, the auditor should obtain an understanding of the audit requirements for that particular program from the agreement with the grantor agency, from an audit guide published by the grantor agency, or through contact with the grantor agency.

.97 The testing and reporting responsibilities of an engagement to conduct a program-specific audit will vary depending on the requirements of the grantor agency. Those responsibilities may differ from those addressed in this section. The guidance provided in this section should be applied to these engagements as it is applicable to the specific program.

### State and Local Laws and Regulations

.98 An auditor may also be engaged to test and report on compliance with state and local laws and regulations other than those discussed in the preceding paragraphs of this section.

.99 In such cases, auditors should consider performing the following procedures:

- a. Inquire of management about additional compliance auditing requirements applicable to the entity.

- b. Inquire of the office of the state or local auditor or other appropriate audit oversight organization about audit requirements applicable to the entity.
- c. Review information about governmental audit requirements available from state societies of CPAs or associations of governments.

## Effective Date

.100 The provisions of this section are effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after June 15, 1992. Early application of this section is encouraged.

## Transitional Guidance

.101 The auditor should be aware that the OMB issued a revised Compliance Supplement for State and Local Governments in September 1990 that requires that the general requirements “be included as part of every audit of State, local, and Tribal government that involves federal financial assistance whether or not the government has a major program.” Although this section, which provides guidance on the revised requirements, is not effective immediately, the revised requirements are already effective. To meet the new requirements, the auditor should consider early application of the guidance in paragraphs .47 and .49 of this section. Furthermore, auditors should be aware that existing federal requirements, such as OMB Circular A-133 and the Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions, may have effective dates that precede the effective date of this section.

**.102 Appendix A****Audit and Reporting Requirements Under the Single Audit Act and OMB Circular A-128, or Under OMB Circular A-133**

The following table shows procedures performed and reports issued in an audit in accordance with the Single Audit Act of 1984 and OMB Circular A-128, or in accordance with OMB Circular A-133. The table refers to guidance on procedures or reports that differ from those ordinarily performed or issued in an audit conducted in accordance with generally accepted auditing standards. Additional guidance may be found in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and related AICPA statements of position. The AICPA plans to issue a statement of position that would provide guidance on OMB Circular A-133 requirements.

Procedures PerformedReport Issued

- |  |   |
|--|---|
| 1. Audit of the financial statements in accordance with generally accepted auditing standards  | ● Opinion on the financial statements   |
| 2. Audit of the financial statements in accordance with <i>Government Auditing Standards</i>   | ● Report on supplementary schedule of federal financial assistance  |
| 3. Obtain an understanding of the internal control structure over federal financial assistance, assess control risk, and perform tests of controls   | ● Report on internal control structure-related matters based solely on an assessment of control risk performed as part of the audit of the financial statements |
| 4. Testing of compliance with general requirements applicable to federal financial assistance programs and audit of compliance with specific requirements applicable to major federal financial assistance programs as defined by the Single Audit Act or OMB Circular A-133 | ● Report on compliance with laws and regulations that may have a material effect on the financial statements  |
| 5. Testing of compliance with laws and regulations applicable to nonmajor federal financial assistance program transactions selected for testing in connection with procedure 1 or 3   | ● Report on internal controls over federal financial assistance   |
|  | ● Report on compliance with general requirements applicable to federal financial assistance programs  |
|  | ● Opinion on compliance with specific requirements applicable to <i>each</i> major federal financial assistance program   |
|  | ● Schedule of findings and questioned costs   |
|  | ● Report on compliance with laws and regulations applicable to nonmajor federal financial assistance program transactions tested                                |
|  | ● Schedule of findings and questioned costs   |

**.103 Appendix B****Examples of Effects of Certain Laws and Regulations on a Governmental Entity's Financial Statements**

1. Following are some of the types of laws and regulations that may have a direct and material effect on the determination of amounts in a governmental entity's financial statements. These types of laws and regulations may be relevant to an entity whether or not it is legally required to prepare financial statements in accordance with generally accepted accounting principles.

- a. *Reporting entity*—For those entities required by law or regulation to prepare financial statements in accordance with generally accepted accounting principles, section 2100 of the GASB *Codification* establishes criteria for determining the organizations, functions, and activities of government that should be included in the general purpose financial statements of a governmental entity. These criteria include manifestation of oversight responsibility, accountability for fiscal matters, scope of public services, and special financing relationships. In applying these criteria to define the reporting entity, management should consider applicable laws and regulations.
- b. *Establishment of funds*—Section 1300 of the GASB *Codification* establishes the principles of fund accounting. It notes that—

Various types of legal provisions require establishment of funds. At the state level, funds may be created pursuant to constitutional provisions or statutes enacted by the legislative body. A local government's funds may be established by state constitutional provisions or statutes, or by local charters, ordinances, and governing body orders.

For example, a state constitution may require that proceeds of a state gasoline tax be accounted for in a special revenue fund.

- c. *Budgetary reporting*—An appropriated budget is the expenditure authority created by appropriation bills or ordinances that are signed into law and the related estimated revenues. Section 2400 of the GASB *Codification* requires that the general purpose financial statements present an aggregation of the appropriated budgets, as amended, compared to actual results of operations.
- d. *Matching requirements*—A grantor may require grantees to contribute their own resources toward carrying out the activity funded with a grant. A grant is a contribution of cash or other assets from another government to be used or expended for a specified purpose, activity, or facility. Section G60.109 of the GASB *Codification* states that if such matching requirements exist, revenue recognition depends on compliance with those requirements.
- e. *Restrictions on expenditures*—The purposes for which the proceeds of certain governmental revenues may be expended are restricted by law. For example, a state constitution may require that proceeds of a state gasoline tax be expended only for maintenance of highways. Similarly, legislation enacting a housing grant program may require governmental entities receiving the grant to distribute the proceeds

only to families meeting certain eligibility tests. Restrictions on expenditures do not necessarily require establishment of a special revenue fund. Section 1300.107 of the GASB *Codification* notes that “resources restricted to expenditure for purposes normally financed from the general fund may be accounted for through the general fund provided that applicable legal requirements can be appropriately satisfied, and use of special revenue funds is not required unless they are legally mandated.”

- f. *Taxing and debt limitations*—Certain governmental entities may be subject to laws and regulations that place limits on local government taxing authority, place ceiling limitations and other issuance criteria on debt, or place limits on the use of debt proceeds.
- g. *General requirements*—Certain of the general requirements identified in the OMB’s *Compliance Supplement* may have a direct and material effect on the determination of financial statement amounts in certain circumstances. For example, indirect costs may not have been properly allocated to federal programs. Such an action would be a violation of OMB Circular No. A-87, “Cost Principles for State and Local Governments,” referred to in the allowable costs/cost principles general requirement, and would have a direct effect on the determination of cost-related amounts in the entity’s financial statements.

2. The GASB *Codification* also includes requirements to disclose violations of certain laws and regulations. Section 2300.104 of the GASB *Codification* states: “Notes to the financial statements essential to fair presentation at the GPFS [general purpose financial statements] level include . . . [m]aterial violations of finance-related legal and contractual provisions.” The auditor’s consideration of the adequacy of such disclosure includes an evaluation of the governmental entity’s compliance with laws and regulations that could have a direct and material effect on the determination of financial statement amounts. The following are examples of violations of those laws and regulations that a governmental entity may be required to disclose:

- a. Failure to establish funds required by law
- b. Expenditures in excess of a legally appropriated budget
- c. Expenditure of the proceeds of a grant without satisfying matching requirements
- d. Expenditure of the proceeds of a tax in violation of legal restrictions on use of those proceeds
- e. Issuance of debt in excess of ceiling limitations imposed by law

3. In section 150.161 and .162, the GASB *Codification* specifically requires governmental entities to disclose the types of investments they are legally authorized to make and any violations of legal or contractual provisions for deposits and investments. When these disclosures have been made by management, the auditor should also evaluate a governmental entity’s compliance with legal provisions for deposits and investments. The auditor’s responsibility to evaluate compliance with these legal provisions arises since the disclosures are specifically required by generally accepted accounting principles, not because the legal provisions have a direct and material effect on the determination of financial statement amounts.



## .104 Glossary

**Award.** Defined by OMB Circular A-133 as financial assistance and federal cost-type contracts used to buy services or goods for the use of the federal government. It does not include procurement contracts to vendors under grants or contracts used to buy goods or services.

**Catalog of Federal Domestic Assistance.** A government-wide summary of federal programs, services, and activities administered by the departments and establishments of the federal government that provide assistance and benefits to the U.S. public.

**Common Rule.** Issued by federal agencies to implement OMB Circular A-102, "Uniform Requirements for Grants to State and Local Governments." Establishes uniform administrative rules for federal grants and cooperative agreements and subawards to state, local, and Indian Tribal governments. The rules, which apply to grants awarded on or after October 1, 1988, are organized according to the major steps in the grants process: pre-award, post-award, and after-the-grant.

**Compliance Supplements.** Published by the OMB to specify the general and specific program compliance requirements and suggested audit procedures for federal programs. There are two compliance supplements: the supplement to OMB Circular A-128, *Compliance Supplement for Single Audits of State and Local Governments* (revised September 1990), and the supplement to OMB Circular A-133, *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*.

**Disallowed cost.** Defined by the Inspector General Act Amendments of 1988 as a questioned cost that management, in a management decision, has sustained or agreed should not be charged to the government.

**Earmarking.** Laws and regulations specific to a program that specify the nature of projects that organizations may fund with financial assistance received from the government.

**GAO.** The United States General Accounting Office, the main purposes of which are (1) to assist Congress in carrying out legislative and oversight responsibilities; (2) to carry out legal, accounting, auditing, and claims settlement functions with respect to federal government programs; and (3) to make recommendations for providing more efficient and effective government operations.

**General requirements.** Specified in the *Compliance Supplements* as "those requirements that involve significant national policy and of which failure to comply could have a material impact on an organization's financial statements." Accordingly, tests for compliance with those requirements "should be included as a part of every audit of state, local, and Tribal governments that involves federal financial assistance." Those requirements pertain to the following matters:

- a. *Political activity* prohibits the use of federal funds for partisan political activity.
- b. *Davis-Bacon Act* requires that laborers working on federally financed construction contracts be paid a wage established by the Secretary of Labor.
- c. *Civil rights* prohibit violation of anyone's civil rights in a program funded by the federal government.

- d. *Cash management* requires recipients of federal assistance to minimize the time lapsed between receipt and disbursement of that assistance.
- e. *Relocation assistance and real property acquisition* prescribe how real property should be acquired with federal financial assistance and how recipients must help relocate people displaced when that property is acquired.
- f. *Federal financial reports* prescribe federal financial reports that must be filed.
- g. *Allowable costs/cost principles* require that costs charged to programs comply with federal cost principles.
- h. *Drug-Free Workplace Act* requires recipients to certify that they will provide a drug-free workplace.
- i. *Administrative requirements* require compliance with the applicable administrative requirements in the common agency regulations.

**Government Auditing Standards.** Issued by the Comptroller General of the United States as the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions* (1988 Revision), this document contains audit standards that must be followed for audits of federal organizations, programs, activities, functions, and funds received by contractors, nonprofit organizations, and other external organizations. The document is also recommended for audits of state and local government organizations, programs, activities, and functions.

**Level of effort.** Laws and regulations specific to a program that require an organization that receives financial assistance from the government to maintain a specified level of participation through the contribution of the organization's resources.

**Major federal award program.** Defined by OMB Circular A-133 as an individual award or group of awards in a category of federal assistance or support for which total expenditures are the larger of 3 percent of total federal funds expended or \$100,000. Each of the following categories of federal awards shall constitute a major program, in which total expenditures are the larger of 3 percent of total federal funds expended or \$100,000:

- a. Research and development.
- b. Student financial aid.
- c. Individual awards not in the student aid or research-and-development category.

**Major federal financial assistance program.** Defined by the Single Audit Act as any federal financial assistance program for which total expenditures of that assistance during the applicable program year exceed—

- a. \$20 million, when expenditures for all programs exceed \$7 billion.
- b. \$19 million, when expenditures for all programs exceed \$6 billion but are less than or equal to \$7 billion.
- c. \$16 million, when expenditures for all programs exceed \$5 billion but are less than or equal to \$6 billion.
- d. \$13 million, when expenditures for all programs exceed \$4 billion but are less than or equal to \$5 billion.
- e. \$10 million, when expenditures for all programs exceed \$3 billion but are less than or equal to \$4 billion.

- f. \$7 million, when expenditures for all programs exceed \$2 billion but are less than or equal to \$3 billion.
- g. \$4 million, when expenditures for all programs exceed \$1 billion but are less than or equal to \$2 billion.
- h. \$3 million, when expenditures for all programs exceed \$100 million but are less than or equal to \$1 billion.
- i. The larger of \$300,000 or 3 percent of total expenditures for all programs, when expenditures for all programs exceed \$100,000 but are less than or equal to \$100 million.

**Noncompliance.** The failure to act in accordance with the laws, regulations, and contractual terms governing financial assistance that an entity received from a governmental agency.

**Nonmajor federal financial assistance program.** All federal financial assistance programs that do not meet the specified criteria of a major program.

**OMB.** The United States Office of Management and Budget.

**OMB Circular A-21.** “Cost Principles for Educational Institutions,” issued by the OMB to provide that federal assistance programs provided to educational institutions bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

**OMB Circular A-87.** “Cost Principles for State and Local Governments,” issued by the OMB to provide that federal assistance programs provided to state and local governments and Indian Tribal governments bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

**OMB Circular A-102.** “Uniform Requirements for Grants to State and Local Governments,” issued by the OMB to provide a uniform approach for administration of federal assistance programs.

**OMB Circular A-110.** “Uniform Requirements for Grants to Universities, Hospitals, and Other Nonprofit Organizations,” issued by the OMB to establish standards (such as insurance requirements, record retention requirements, and banking requirements) for obtaining consistency and uniformity among federal agencies in the administration of grants to and agreements with public and private institutions of higher education, public and private hospitals, and other quasi-public and private nonprofit organizations. Does not apply to grants, contracts, and other agreements between the federal government and units of state and local governments.

**OMB Circular A-122.** “Cost Principles for Nonprofit Organizations,” issued by the OMB to provide that federal assistance programs provided to nonprofit organizations bear their fair share of costs by defining costs that are allowable and unallowable for that assistance. This circular does not apply to—

- a. Colleges and universities.
- b. State, local, and Indian Tribal governments.
- c. Hospitals.

**OMB Circular A-128.** “Audits of State and Local Governments,” issued by the OMB to facilitate the implementation of the Single Audit Act of 1984, establishes specific audit requirements for state and local governments that receive federal financial assistance and defines federal responsibilities for implementing and monitoring those requirements.

**OMB Circular A-133.** “Audits of Institutions of Higher Education and Other Nonprofit Institutions,” issued by the OMB to establish audit requirements

for institutions of higher education and other nonprofit institutions receiving federal awards and to define federal responsibilities for implementing and monitoring those requirements.

**Primary recipient.** The entity receiving governmental financial assistance directly from the governmental program creating and providing the financial assistance.

**Questioned cost.** Defined in the Inspector General Act Amendments of 1988 as (1) an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds; (2) a finding that, at the time of the audit, such cost is not supported by adequate documentation; or (3) a finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable.

**Single Audit Act of 1984.** The United States federal statute (Public Law 98-502) that establishes uniform requirements for audits of federal financial assistance provided to state and local governments. These requirements focus on a single coordinated audit of the aggregate federal financial assistance provided to a government, with special emphasis on defined major federal financial assistance programs. The requirements include—

- a. An audit of the general purpose financial statements.
- b. Additional tests for compliance with applicable laws and regulations related to federal assistance programs received.
- c. Reviews of internal control systems for federal financial assistance received.

**Specific requirements.** Defined in the *Compliance Supplements* as those requirements that pertain to the following categories:

- a. Types of services allowed or unallowed.
- b. Eligibility.
- c. Matching, level of effort, or earmarking.
- d. Reporting.
- e. Special tests and provisions.

In addition to these five requirements, the auditor should consider the requirements listed in paragraph .59 of this section when reporting on compliance with specific requirements.

**Subrecipient.** An entity receiving governmental financial assistance when that assistance is initially received by another entity that distributes the assistance for the government program that created and provided the assistance.

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## AU Section 900

# SPECIAL REPORTS OF THE COMMITTEE ON AUDITING PROCEDURE

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... public warehouses—internal control structure policies and procedures and auditing procedures for goods held ...

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[The next page is 1451.]

**AU Section 901*****Public Warehouses—Internal Control  
Structure Policies and Procedures  
and Auditing Procedures  
for Goods Held***

Sources: SAS No. 1, section 901; SAS No. 43.

Issue date, unless otherwise indicated: November, 1972.

**Introduction**

.01 This section discusses internal control structure policies and procedures of a public warehouse, the procedures of its independent auditor with respect to goods in the warehouse's custody, and auditing procedures performed by the independent auditor of the owner of goods in the warehouse.<sup>1</sup> [As amended, (by replacing paragraphs .01 through .05 with a new paragraph .01), effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

**General Considerations**

.02 The management of a business has the responsibility for the proper recording of transactions in its books of account, for the safeguarding of its assets, and for the substantial accuracy and adequacy of its financial statements. The independent auditor is not an insurer or guarantor; his responsibility is to express a professional opinion on the financial statements he has audited.<sup>2</sup> [Formerly paragraph .06, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

**Summary of Recommendations**

.03 The Committee recommends that the independent auditor of the warehouseman:

- a. Obtain an understanding of internal control structure policies and procedures, relating to the accountability for and the custody of all goods placed in the warehouse and perform tests of controls to evaluate their effectiveness.
- b. Test the warehouseman's records relating to accountability for all goods placed in his custody.
- c. Test the warehouseman's accountability under recorded outstanding warehouse receipts.

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<sup>1</sup> This section reports the conclusions of a 1966 study of the AICPA Committee on Auditing Procedure on the accountability of warehousemen for goods stored in public warehouses. [Footnote changed by issuance of Statement on Auditing Standards No. 43.]

<sup>2</sup> See section 110.

- d. Observe physical counts of the goods in custody, wherever practicable and reasonable, and reconcile his tests of such counts with records of goods stored.
- e. Confirm accountability (to the extent considered necessary) by direct communication with the holders of warehouse receipts.

The independent auditor should apply such other procedures as he considers necessary in the circumstances. [Formerly paragraph .07, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

**.04** Warehousing activities are diverse because the warehoused goods are diverse, the purposes of placing goods in custody are varied, and the scope of operations of warehouses is not uniform. The independent auditor has the responsibility to exercise his judgment in determining what procedures, including those recommended in this report, are necessary in the circumstances to afford a reasonable basis for his opinion on the financial statements.<sup>3</sup> [Formerly paragraph .08, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

**.05** The following sections of this report describe those aspects of warehousing operations of primary concern to independent auditors, suggest elements of the internal control structure for warehousemen, and offer the Committee's recommendations as to procedures of the independent auditor. [Formerly paragraph .09, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

## Public Warehouse Operations

### Types of Warehouses

**.06** A warehouse may be described as a facility operated by a warehouseman whose business is the maintaining of effective custody of goods for others. [Formerly paragraph .10, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

**.07** Warehouses may be classified functionally as terminal warehouses or field warehouses:

***Terminal Warehouse.*** The principal economic function of a terminal warehouse is to furnish storage. It may, however, perform other functions, including packaging and billing. It may be used to store a wide variety of goods or only a particular type of commodity.

***Field Warehouse.*** A field warehouse is established in space leased by the warehouseman on the premises of the owner of the goods or the premises of a customer of the owner. In most circumstances all or most of the personnel at the warehouse location are employed by the warehouseman from among the employees of the owner (or customer), usually from among those who previously have been responsible for custody and handling of the goods. Field warehousing is essentially a financing arrangement, rather than a storage operation. The warehouse is established to permit the warehouse-

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<sup>3</sup> See section 326. (Reference changed by issuance of Statement on Auditing Standards No. 31.)

man to take and maintain custody of goods and issue warehouse receipts to be used as collateral for a loan or other form of credit.

Warehouses may be classified also by types of goods stored. Foods and other perishable products may be stored in refrigerated warehouses, constructed and equipped to meet controlled temperature and special handling requirements. Certain bulk commodities, such as various agricultural products and chemicals, are stored in commodity warehouses; these warehouses often are designed and equipped to store only one commodity, and fungible goods frequently are commingled without regard to ownership. A wide variety of goods, usually not requiring special storage facilities, is stored in general merchandise warehouses. Some warehouses confine their activities to storing furniture, other household goods, and personal effects. [Formerly paragraph .11, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

### Warehouse Receipts

**.08** A basic document in warehousing is the warehouse receipt. Article 7 of the Uniform Commercial Code regulates the issuance of warehouse receipts, prescribes certain terms that must be contained in such receipts, provides for their negotiation and transfer, and establishes the rights of receipt holders. [Formerly paragraph .12, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

**.09** Warehouse receipts may be in negotiable form or non-negotiable form and may be used as evidence of collateral for loans or other forms of credit. Goods represented by a negotiable warehouse receipt may be released only upon surrender of the receipt to the warehouseman for cancellation or endorsement, whereas goods represented by a non-negotiable receipt may be released upon valid instructions without the need for surrender of the receipt. Other important ways in which the two kinds of receipts differ concern the manner in which the right of possession to the goods they represent may be transferred from one party to another and the rights acquired by bona fide purchasers of the receipts. [Formerly paragraph .13, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

**.10** Since goods covered by non-negotiable receipts may be released without surrender of the receipts, such outstanding receipts are not necessarily an indication of accountability on the part of the warehouseman or of evidence of ownership by the depositor. Since goods are frequently withdrawn piecemeal, the warehouseman's accountability at any given time is for the quantity of goods for which receipts have been issued minus the quantities released against properly authorized withdrawals. [Formerly paragraph .14, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

**.11** Article 7 of the Uniform Commercial Code, in addition to provisions with respect to the issuance and contents of warehouse receipts, contains provisions with respect to, among other things, the storage and release of warehoused goods, the standard of care to be exercised by the warehouseman, warehouseman's liability, and liens for the warehouseman's charges and expenses and the manner in which they may be enforced. [Formerly paragraph .15, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]



## Government Regulation

.12 There are various other statutes and regulations, applicable in special situations, relating to the rights and duties of warehousemen and the operation of warehouses. Among the more important are (a) the United States Warehouse Act and the regulations adopted thereunder by the Department of Agriculture, providing for licensing and regulation of warehouses storing certain agricultural commodities, (b) the regulations adopted by commodity exchanges licensed under the United States Commodity Exchange Act, providing for issuance and registration of receipts and licensing and regulation of warehouses, and (c) the Internal Revenue Code and the Tariff Act of 1930, and regulations adopted thereunder, relating respectively to United States Revenue Bonded Warehouses and United States Customs Bonded Warehouses, providing for licensing, bonding, and regulation of such warehouses. In addition, there are statutes and regulations in various states relating to licensing, bonding, insurance, and other matters. [Formerly paragraph .16, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

## The Warehouseman

### Internal Control Structure Policies and Procedures

.13 Goods held in custody for others are not owned by the warehouseman and, therefore, do not appear as assets in his financial statements. Similarly, the related custodial responsibility does not appear as a liability. However, as in other businesses, the warehouseman is exposed to the risk of loss or claims for damage stemming from faulty performance of his operating functions. Faulty performance may take the form of loss or improper release of goods, improper issuance of warehouse receipts, failure to maintain effective custody of goods so that lenders' preferential liens are lost, and other forms. [Formerly paragraph .17, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.14 The recommendation herein that the independent auditor of the warehouseman obtain an understanding of relevant internal control structure policies and procedures and perform tests of controls to evaluate their effectiveness is based upon the important relationship of such internal control structure policies and procedures to the custodial responsibilities of the warehouseman, which are not reflected in his financial statements. Significant unrecorded liabilities may arise if these custodial responsibilities are not discharged properly. [Formerly paragraph .18, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Paragraph amended to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.]

.15 Whether and to what extent the suggested control procedures that follow may be applicable to a particular warehouse operation will depend on the nature of the operation, of the goods stored, and of the warehouseman's organization. Appropriate segregation of duties in the performance of the respective operating functions should be emphasized.

### *Receiving, Storing, and Delivering Goods*

Receipts should be issued for all goods admitted into storage.

Receiving clerks should prepare reports as to all goods received. The receiving report should be compared with quantities shown on bills of lading or other documents received from the owner or other outside sources by an employee independent of receiving, storing, and shipping.

Goods received should be inspected, counted, weighed, measured, or graded in accordance with applicable requirements. There should be a periodic check of the accuracy of any mechanical facilities used for these purposes.

Unless commingling is unavoidable, such as with fungible goods, goods should be stored so that each lot is segregated and identified with the pertinent warehouse receipt. The warehouse office records should show the location of the goods represented by each outstanding receipt.

Instructions should be issued that goods may be released only on proper authorization which, in the case of negotiable receipts, includes surrender of the receipt.

Access to the storage area should be limited to those employees whose duties require it, and the custody of keys should be controlled.

Periodic statements to customers should identify the goods held and request that discrepancies be reported to a specified employee who is not connected with receiving, storing, and delivery of goods.

The stored goods should be physically counted or tested periodically, and quantities agreed to the records by an employee independent of the storage function; the extent to which this is done may depend on the nature of the goods, the rate of turnover, and the effectiveness of other internal control structure policies and procedures.

Where the goods held are perishable, a regular schedule for inspection of condition should be established.

Protective devices such as burglar alarms, fire alarms, sprinkler systems, and temperature and humidity controls should be inspected regularly.

Goods should be released from the warehouse only on the basis of written instructions received from an authorized employee who does not have access to the goods.

Counts of goods released as made by stock clerks should be independently checked by shipping clerks or others and the two counts should be compared before the goods are released.

### *Warehouse Receipts*

Prenumbered receipt forms should be used, and procedures established for accounting for all forms used and for cancellation of negotiable receipts when goods have been delivered.

Unused forms should be safeguarded against theft or misuse and their custody assigned to a responsible employee who is not authorized to prepare or sign receipts.

Receipt forms should be furnished only to authorized persons, and in a quantity limited to the number required for current use.

The signer of receipts should ascertain that the receipts are supported by receiving records or other underlying documents.

Receipts should be prepared and completed in a manner designed to prevent alteration.

Authorized signers should be a limited number of responsible employees.

### *Insurance*

The adequacy, as to both type and amount, of insurance coverage carried by the warehouseman should be reviewed at appropriate intervals.

[Formerly paragraph .19, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

### **Additional Internal Control Structure Policies and Procedures for Field Warehouses**

.16 As indicated earlier, the purpose of field warehousing differs from terminal warehousing. Operating requirements also may differ because a field warehouseman may operate at a large number of locations. [Formerly paragraph .20, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.17 In field warehousing, internal control structure policies and procedures are applied at two points: the field location and the warehouseman's central office. At the field location, the internal control structure policies and procedures as to receipt, storage, and delivery of goods and issuance of warehouse receipts generally will comprise the internal control structure policies and procedures suggested above, with such variations as may be appropriate in light of the requirements, and available personnel, at the respective locations. Only non-negotiable warehouse receipts should be issued from field locations, and the receipt forms should be furnished to the field locations by the central office in quantities limited to current requirements. [Formerly paragraph .21, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.18 The central office should investigate and approve the field warehousing arrangements, and exercise control as to custody and release of goods and issuance of receipts at the field locations. Internal control structure policies and procedures suggested for the central office are the following:

Consideration of the business reputation and financial standing of the depositor.

Preparation of a field warehouse contract in accordance with the particular requirements of the depositor and the lender.

Determination that the leased warehouse premises meet the physical requirements for segregation and effective custody of goods.

Satisfaction as to legal matters relative to the lease of the warehouse premises.

Investigation and bonding of the employees at the field locations.

Providing employees at field locations with written instructions covering their duties and responsibilities.

Maintenance of inventory records at the central office showing the quantity (and stated value, where applicable) of goods represented by each outstanding warehouse receipt.

Examination of the field warehouse by representatives of the central office. These examinations would include inspection of the facilities, observation as to adherence to prescribed procedures, physical counts or tests of goods in custody and reconciliation of quantities to records at the central office and at field locations, accounting for all receipt forms furnished to the field locations, and confirmation (on a test basis, where appropriate) of outstanding warehouse receipts with the registered holders.

[Formerly paragraph .22, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

### Procedures of the Independent Auditor

.19 The Committee recommends that the independent auditor of the warehouseman:

- a. Obtain an understanding of internal control structure policies and procedures, relating to the accountability for and the custody of all goods placed in the warehouse and perform tests of controls to evaluate their effectiveness.
- b. Test the warehouseman's records relating to accountability for all goods placed in his custody.
- c. Test the warehouseman's accountability under recorded outstanding warehouse receipts.
- d. Observe physical counts of the goods in custody, wherever practicable and reasonable, and reconcile his tests of such counts with records of goods stored.
- e. Confirm accountability (to the extent considered necessary) by direct communication with the holders of warehouse receipts.

The independent auditor should apply such other procedures as he considers necessary in the circumstances. [Formerly paragraph .23, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.20 The auditor's procedures relating to accountability might include, on a test basis, comparison of documentary evidence of goods received and delivered with warehouse receipts records, accounting for issued and unissued warehouse receipts by number, and comparison of the records of goods stored with billings for storage. In some circumstances, the auditor may consider it necessary to obtain confirmation from the printer as to the serial numbers of receipt forms supplied. [Formerly paragraph .24, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982. Subsequently, reference changed by the issuance of Statement on Auditing Standards No. 48.]

.21 In the case of a field warehouseman where goods are stored at many scattered locations, the independent auditor may satisfy himself that the

warehouseman's physical count procedures are adequate by observing the procedures at certain selected locations. The amount of testing required will be dependent upon the effectiveness of both design and operation of internal control structure policies and procedures. [Formerly paragraph .25, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.22 The confirmation of negotiable receipts with holders may be impracticable, since the identity of the holders usually is not known to the warehouseman. Confirmation with the depositor to whom the outstanding receipt was originally issued, however, would be evidential matter of the accountability for certain designated goods. It should be recognized, too, that as to both negotiable and non-negotiable receipts, confirmation may not be conclusive in the light of the possibility of issued but unrecorded receipts. In some circumstances, it may be desirable to request confirmations from former depositors who are not currently holders of record. [Formerly paragraph .26, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.23 The independent auditor should review the nature and extent of the warehouseman's insurance coverage and the adequacy of any reserves for losses under damage claims. [Formerly paragraph .27, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

## **Internal Control Structure Policies and Procedures and Auditing Procedures for Owner's Goods Stored in Public Warehouses**

.24 The following paragraphs provide guidance on the elements of the internal control structure for the owner of the goods and on the auditing procedures to be employed by his independent auditor. [As amended, (formerly paragraph .28) effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

### **Internal Control Structure Policies and Procedures**

.25 The internal control structure policies and procedures of the owner should be designed to provide reasonable safeguards over his goods in a warehouseman's custody. Ordinarily, the internal control structure policies and procedures should include an investigation of the warehouseman before the goods are placed in custody, and a continuing evaluation of the warehouseman's performance in maintaining custody of the goods. [Formerly paragraph .29, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.26 Among the suggested internal control structure policies and procedures that may be comprehended in an investigation of the warehouseman before the goods are placed in his custody are the following:

Consideration of the business reputation and financial standing of the warehouseman.

Inspection of the physical facilities.

Inquiries as to the warehouseman's internal control structure policies and procedures and whether the warehouseman holds goods for his own account.

Inquiries as to type and adequacy of the warehouseman's insurance.

Inquiries as to government or other licensing and bonding requirements and the nature, extent, and results of any inspection by government or other agencies.

Review of the warehouseman's financial statements and related reports of independent auditors. [Formerly paragraph .30, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

.27 After the goods are placed in the warehouse, suggested internal control structure policies and procedures that may be applied periodically by the owner in evaluating the warehouseman's performance in maintaining custody of goods include the following:

Review and update the information developed from the investigation described above.

Physical counts (or test counts) of the goods, wherever practicable and reasonable (may not be practicable in the case of fungible goods).

Reconcilement of quantities shown on statements received from the warehouseman with the owner's records.

In addition, he should review his own insurance, if any, on goods in the custody of the warehouseman. [Formerly paragraph .31, number changed by issuance of Statement on Auditing Standards No. 43, effective after August 31, 1982.]

### **Procedures of the Independent Auditor**

.28 Section 331.14, describes the procedures that the auditor should apply if inventories are held in public warehouses. [As amended, (formerly paragraph .32) by Statement on Auditing Standards No. 43, effective after August 31, 1982.]

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**AU**

**APPENDIXES**

... historical background ... statements on auditing procedure/standards/standards for attestation engagements ... sources of sections ... cross-references for auditing interpretations ... audit and accounting guides, and statements of position ... changes in statements on auditing standards ...

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## AU Appendix A

### *Historical Background*

#### **The "Bulletins" of 1917, 1918, 1929, and 1936**

In 1917, the American Institute of Certified Public Accountants, then known as the American Institute of Accountants, at the request of the Federal Trade Commission, prepared "a memorandum on balance-sheet audits," which the Commission approved and transmitted to the Federal Reserve Board.

The Federal Reserve Board, after giving the memorandum its provisional endorsement, published it in the *Federal Reserve Bulletin* of April 1917; reprints were widely disseminated for the consideration of "banks, bankers, banking associations; merchants, manufacturers, and associations of manufacturers; auditors, accountants, and associations of accountants" in pamphlet form with the title of "Uniform Accounting: a Tentative Proposal Submitted by the Federal Reserve Board."

In 1918, it was reissued under the same sponsorship, with a new title—"Approved Methods for the Preparation of Balance-Sheet Statements." There was practically no change from 1917 except that, as indicated by the respective titles and corresponding change in the preface, instead of the objective of "a uniform system of accounting to be adopted by manufacturing and merchandising concerns," the new objective was "the preparation of balance-sheet statements" for the same businesses.

In 1929, a special committee of the American Institute undertook revision of the earlier pamphlet in the light of the experience of the past decade; again under the auspices of the Federal Reserve Board, the revised pamphlet was issued in 1929 as "Verification of Financial Statements."

The preface of the 1929 pamphlet spoke of its predecessors as having been criticized, on the one hand, by some accountants for being "more comprehensive than their conception of the so-called balance-sheet audit," and, on the other hand, by other accountants because "the procedure would not bring out all the desired information." This recognition of opposing views evidenced the growing realization of the impracticability of uniform procedures to fit the variety of situations encountered in practice. Of significance is the appearance in the opening paragraph of "General Instructions" in the 1929 publication of the statement:

The extent of the verification will be determined by the conditions in each concern. In some cases, the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditor.

Between 1932 and 1934, there was correspondence, dealing with both accounting and auditing matters, between the Institute's special committee on cooperation with stock exchanges and the committee on stock list of the New York Stock Exchange. The views expressed were an important development in the recognition of the position of accountancy in finance and business. The series of letters was published in 1934 under the title *Audits of Corporate Accounts*.



In 1936, a committee of the Institute prepared and published a further revision of the earlier pamphlets under the title of "Examination of Financial Statements by Independent Public Accountants." The Institute availed itself of the views of persons outside the ranks of the profession whose opinions would be helpful, but the authority behind and responsibility for the publication of the pamphlet rested wholly with the Institute as the authoritative representative of a profession that had by that time become well established in the business community.

In the 1936 revision, aside from the very briefly noted "Modifications of Program for Larger or Smaller Companies," the detailed procedures were restrictively stated to be an "outline of examination of financial statements of a small or moderate size company." Moreover, the nature and extent of such examinations were based on the purpose of the examination, the required detail to be reported on, the type of business, and, most important of all, the system of internal control; variations in the extent of the examination were specifically related to "the size of the organization and the personnel employed" and were said to be "essentially a matter of judgment which must be exercised by the accountant."

It is possible from the foregoing narrative to trace the development of the profession's view of an audit based on the experience of three decades. The succession of titles is illustrative. The earliest ambition for "uniform accounting" was quickly realized to be unattainable, and the same listed procedures were related instead to "balance-sheet statements." Then, with the gradually greater emphasis on periodic earnings, the earlier restrictive consideration of the balance sheet was superseded in the 1929 title, "Verification of Financial Statements," by according the income statement at least equal status. When in turn the 1936 revision was undertaken, there was a growing realization that, with the complexity of modern business and the need of the independent auditor to rely on testing, such a word as "verification" was not an accurate portrayal of the independent auditor's function. Accordingly, the bulletin of that year was stated to cover an "examination" of financial statements.

## Statements on Auditing Procedure

The Committee on Auditing Procedure had its beginning on January 30, 1939, when the executive committee of the Institute authorized the appointment of a small committee "to examine into auditing procedure and other related questions in the light of recent public discussion."

On May 9 of that year, the report "Extensions of Auditing Procedure" of this special committee was adopted by the Council of the Institute and authority given for its publication and distribution, and in the same year the bylaws were amended to create a standing Committee on Auditing Procedure.

In 1941, the executive committee authorized the issuance to Institute members, in pamphlet form, of the "Statements on Auditing Procedure," prepared by the Committee on Auditing Procedure, previously published only in *The Journal of Accountancy*.

The "Statements on Auditing Procedure" were designed to guide the independent auditor in the exercise of his judgment in the application of auditing procedures. In no sense were they intended to take the place of auditing textbooks; by their very nature textbooks must deal in a general way with the description of procedures and refinement of detail rather than the variety of circumstances encountered in practice that require the independent auditor to exercise his judgment.

Largely to meet this need, the Institute began the series of Statements on Auditing Procedure. The first of these presented the report of the original special committee, as modified and approved, at the Institute's annual meeting on September 19, 1939, and issued under the title of "Extensions of Auditing Procedure."

Statement No. 1 presented conclusions drawn from the experience and tradition of the profession which largely furnished the foundation for the Committee's present structural outline of auditing standards; the other Statements on Auditing Procedure appropriately fit into that structural outline.

The "Codification of Statements on Auditing Procedure" was issued by the Committee on Auditing Procedure in 1951 to consolidate the features of the first 24 pronouncements which were of continuing usefulness.

When the Securities and Exchange Commission adopted the requirement that a representation on compliance with generally accepted auditing standards be included in the independent auditor's report on financial statements filed with the Commission, it became apparent that a pronouncement was needed to define these standards. Accordingly, the Committee undertook a special study of auditing standards (as distinguished from auditing procedures) and submitted a report that was published in October 1947 under the title "Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope." The recommendations of this brochure ceased to be tentative when, at the September 1948 meeting, the membership of the Institute approved the summarized statement of auditing standards.

In 1954 the "tentative" brochure was replaced by the booklet *Generally Accepted Auditing Standards—Their Significance and Scope*, which was issued as a special report of the Committee on Auditing Procedure. This pronouncement also gave recognition to the approval of Statement on Auditing Procedure No. 23 (Revised), "Clarification of Accountant's Report When Opinion Is Omitted" (1949) and the issuance of the "Codification" (1951).

Statement on Auditing Procedure No. 33 was issued in 1963 as a consolidation of, and a replacement for, the following pronouncements of the Committee on Auditing Procedure: Internal Control (1949), Generally Accepted Auditing Standards (1954), Codification of Statements on Auditing Procedure (1951), and Statements on Auditing Procedure Nos. 25-32, which were issued between 1951 and 1963. Statement No. 33 was a codification of earlier Committee pronouncements which the Committee believed to be of continuing interest to the independent auditor.

## Statements on Auditing Standards

After issuance of Statement on Auditing Procedure No. 33, 21 additional Statements on Auditing Procedure, Nos. 34 to 54, were issued by the Committee on Auditing Procedure. In November 1972, these pronouncements were codified in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures. Also, in 1972, the name of the Committee was changed to the Auditing Standards Executive Committee to recognize its role as the AICPA's senior technical committee charged with interpreting generally accepted auditing standards.

The Auditing Standards Executive Committee issued 22 additional statements through No. 23. These statements were incorporated in the AICPA's looseleaf service, *Professional Standards*, as issued. The looseleaf service began in 1974 and is administered by the AICPA staff. It provides a continuous codification of Statements on Auditing Standards.

## The Auditing Standards Board

As a result of the recommendations of the Commission on Auditors' Responsibilities, an independent study group appointed by the AICPA, a special committee was formed to study the structure of the AICPA's auditing standard-setting activity. In May 1978, the AICPA Council adopted the recommendations of that committee to restructure the Committee. Accordingly, in October 1978 the Auditing Standards Board was formed as the successor to prior senior technical committees on auditing matters. The Board was given the following charge:

The AICPA Auditing Standards Board shall be responsible for the promulgation of auditing standards and procedures to be observed by members of the AICPA in accordance with the Institute's rules of conduct.

The board shall be alert to new opportunities for auditors to serve the public, both by the assumption of new responsibilities and by improved ways of meeting old ones, and shall as expeditiously as possible develop standards and procedures that will enable the auditor to assume those responsibilities.

Auditing standards and procedures promulgated by the board shall—

- a. Define the nature and extent of the auditor's responsibilities.
- b. Provide guidance to the auditor in carrying out his duties, enabling him to express an opinion on the reliability of the representations on which he is reporting.
- c. Make special provision, where appropriate, to meet the needs of small enterprises.
- d. Have regard to the costs which they impose on society in relation to the benefits reasonably expected to be derived from the audit function.

The auditing standards board shall provide auditors with all possible guidance in the implementation of its pronouncements, by means of interpretations of its statements, by the issuance of guidelines, and by any other means available to it.

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## AU Appendix B

### ***List of Statements on Auditing Procedure Nos. 1-54, Statements on Auditing Standards, Statements on Standards for Attestation Engagements, and Statement on Standards for Accountants' Services on Prospective Financial Information Issued to Date***

#### **Statements on Auditing Procedure**

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>
1	Oct. 1939	Extensions of Auditing Procedure
2	Dec. 1939	The Auditor's Opinion on the Basis of a Restricted Examination
3	Feb. 1940	Inventories and Receivables of Department Stores, Instalment Houses, Chain Stores, and Other Retailers
4	March 1941	Clients' Written Representations Regarding Inventories, Liabilities, and Other Matters
5	Feb. 1941	The Revised SEC Rule on "Accountants' Certificates"
6	March 1941	The Revised SEC Rule on "Accountants' Certificates" (continued)
7	March 1941	Contingent Liability Under Policies With Mutual Insurance Companies
8	Sept. 1941	Interim Financial Statements and the Auditor's Report Thereon
9	Dec. 1941	Accountants' Reports on Examinations of Securities and Similar Investments Under the Investment Company Act
10	June 1942	Auditing Under Wartime Conditions
11	Sept. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 2)
12	Oct. 1942	Amendment to Extensions of Auditing Procedure

**Statements on Auditing Procedure—continued**

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>
13	Dec. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 3)—Face-Amount Certificate Companies
14	Dec. 1942	Confirmation of Public Utility Accounts Receivable
15	Dec. 1942	Disclosure of the Effect of Wartime Uncertainties on Financial Statements
16	Dec. 1942	Case Studies on Inventories
17	Dec. 1942	Physical Inventories in Wartime
18	Jan. 1943	Confirmation of Receivables From the Government
19	Nov. 1943	Confirmation of Receivables (Positive and Negative Methods)
20	Dec. 1943	Termination of Fixed Price Supply Contracts
21	July 1944	Wartime Government Regulations
22	May 1945	References to the Independent Accountant in Securities Registrations
23	Dec. 1949	Clarification of Accountant's Report When Opinion is Omitted (Revised)
24	Oct. 1948	Revision in Short-Form Accountant's Report or Certificate
25	Oct. 1954	Events Subsequent to the Date of Financial Statements
26	April 1956	Reporting on Use of "Other Procedures"
27	July 1957	Long-Form Reports
28	Oct. 1957	Special Reports
29	Oct. 1958	Scope of the Independent Auditor's Review of Internal Control
30	Sept. 1960	Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements
31	Oct. 1961	Consistency
32	Sept. 1962	Qualifications and Disclaimers
33	Dec. 1963	Auditing Standards and Procedures (a codification)
34	Sept. 1965	Long-Term Investments
35	Nov. 1965	Letters for Underwriters
36	Aug. 1966	Revision of "Extensions of Auditing Procedure" Relating to Inventories

**Statements on Auditing Procedure—continued**

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>
37	Sept. 1966	Special Report: Public Warehouses—Controls and Auditing Procedures for Goods Held
38	Sept. 1967	Unaudited Financial Statements
39	Sept. 1967	Working Papers
40	Oct. 1968	Reports Following a Pooling of Interests
41	Oct. 1969	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report
42	Jan. 1970	Reporting When a Certified Public Accountant Is Not Independent
43	Sept. 1970	Confirmation of Receivables and Observation of Inventories
44	April 1971	Reports Following a Pooling of Interests
45	July 1971	Using the Work and Reports of Other Auditors
46	July 1971	Piecemeal Opinions
47	Sept. 1971	Subsequent Events
48	Oct. 1971	Letters for Underwriters
49	Nov. 1971	Reports on Internal Control
50	Nov. 1971	Reporting on the Statement of Changes in Financial Position
51	July 1972	Long-Term Investments
52	Oct. 1972	Reports on Internal Control Based on Criteria Established by Governmental Agencies
53	Nov. 1972	Reporting on Consistency and Accounting Changes
54	Nov. 1972	The Auditor's Study and Evaluation of Internal Control

**Statements on Auditing Standards**

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>	<u>Section</u>
1	Nov. 1972	Codification of Auditing Standards and Procedures . . . . .	See Appendix C
2	Oct. 1974	(Superseded by SAS 58.)	
3	Dec. 1974	(Superseded by SAS 48.)	
4	Dec. 1974	(Superseded by SAS 25.)	
5	July 1975	(Superseded by SAS 69.)	

**Statements on Auditing Standards—continued**

<u>No.</u>	<u>Date Issued</u>	<u>Title</u>	<u>Section</u>
6	July 1975	(Superseded by SAS 45.)	
7	Oct. 1975	Communications Between Predecessor and Successor Auditors .....	315
8	Dec. 1975	Other Information in Documents Containing Audited Financial Statements .....	550
9	Dec. 1975	(Superseded by SAS 65.)	
10	Dec. 1975	(Superseded by SAS 24.)	
11	Dec. 1975	Using the Work of a Specialist .....	336
12	Jan. 1976	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments .....	337
13	May 1976	(Superseded by SAS 24.)	
14	Dec. 1976	(Superseded by SAS 62.)	
15	Dec. 1976	(Superseded by SAS 58.)	
16	Jan. 1977	(Superseded by SAS 53.)	
17	Jan. 1977	(Superseded by SAS 54.)	
18	May 1977	(Withdrawn by Auditing Standards Board.)	
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20	Aug. 1977	(Superseded by SAS 60.)	
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\*\* Statement on Auditing Standards No. 45 has created new sections 313, *Substantive Tests Prior to the Balance Sheet Date*; 334, *Related Parties*; and 557, *Supplementary Oil and Gas Reserve Information* (withdrawn by the issuance of SAS No. 52).

\*\*\* Statement on Auditing Standards No. 48 has been integrated within sections 311.03, 311.09—.10, 318.07 (superseded by SAS No. 56.), 320.33—.34 (superseded by SAS No. 55), 320.37 (superseded by SAS No. 55), 320.57—.58 (superseded by SAS No. 55), 320.65—.68 (superseded by SAS No. 55) and 326.12.



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<sup>†</sup> Statement on Auditing Standards No. 52 has been integrated within sections 411.05—.08 (superseded by SAS No. 69) and 551.15 and has created a new section 558, *Required Supplementary Information*.

<sup>††</sup> Statement on Auditing Standards No. 64 has been integrated within sections 341.12, 508.83 and 543.16.

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560.11	Relationship Between Date of Lawyer's Response and Auditor's Report (No. 2) . . . . .	9337.04-.05
560.12	Relationship Between Date of Lawyer's Response and Auditor's Report (No. 2) . . . . .	9337.04-.05
560.12	Inquiry Concerning Litigation, Claims, and Assessments (No. 1) . . . . .	9722.01-.03
561	Restating Financial Statements Reported on by a Prede- cessor Auditor (No. 2) . . . . .	9315.06-.07
561	Auditor Association With Subsequently Discovered Infor- mation When the Auditor Has Resigned or Been Discharged . . . . .	9561.01-.02
622	Reporting on Solvency (No. 6) . . . . .	9504.23-.35
623	Reports on the Financial Statements Included in Internal Revenue Form 990, "Return of Organizations Exempt from Income Tax" (No. 10) . . . . .	9623.47-.54
623.02	Evaluation of the Appropriateness of Information Disclo- sures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis (No. 12) . . . . .	9623.60-.79

<u>Section</u>	<u>Interpretation Subject (Interpretation No.)</u>	<u>Interpretation Section</u>
623.04	Evaluation of the Appropriateness of Information Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis (No. 12) . . . . .	9623.60-.79
623.08	Reports on the Financial Statements Included in Internal Revenue Form 990, "Return of Organizations Exempt from Income Tax" (No. 10) . . . . .	9623.47-.54
623.09	Evaluation of the Appropriateness of Information Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis (No. 12) . . . . .	9623.60-.79
623.10	Evaluation of the Appropriateness of Information Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis (No. 12) . . . . .	9623.60-.79
623.11	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9) . . . . .	9623.40-.46
623.12	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9) . . . . .	9623.40-.46
623.13	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9) . . . . .	9623.40-.46
623.14	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9) . . . . .	9623.40-.46
623.15	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9) . . . . .	9623.40-.46
623.16	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9) . . . . .	9623.40-.46
623.17	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9) . . . . .	9623.40-.46
623.18	Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves (No. 9) . . . . .	9623.40-.46
623.19	Compliance with the Foreign Corrupt Practices Act of 1977 (No. 5) . . . . .	9642.10-.13
623.20	Compliance with the Foreign Corrupt Practices Act of 1977 (No. 5) . . . . .	9642.10-.13
623.21	Compliance with the Foreign Corrupt Practices Act of 1977 (No. 5) . . . . .	9642.10-.13
634.02	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1) . . . . .	9634.01-.09
634.24	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2) . . . . .	9634.10-.12
634.25	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2) . . . . .	9634.10-.12

<i>Section</i>	<i>Interpretation Subject (Interpretation No.)</i>	<i>Interpretation Section</i>
634.26	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2) .....	9634.10-12
634.27	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2) .....	9634.10-12
634.28	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2) .....	9634.10-12
634.29	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2) .....	9634.10-12
634.30	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2) .....	9634.10-12
634.31	Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters (No. 2) .....	9634.10-12
634.40	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1) .....	9634.01-09
634.41	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1) .....	9634.01-09
634.42	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1) .....	9634.01-09
634.43	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1) .....	9634.01-09
634.44	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1) .....	9634.01-09
634.45	Letters to Directors Relating to Annual Reports on Form 10-K (No. 1) .....	9634.01-09
642.12	Compliance With the Foreign Corrupt Practices Act of 1977 (No. 5) .....	9642.10-13
642.37	Reports on Internal Accounting Control of Trust Departments of Banks (No. 6) .....	9642.14-17
642.48	Reports by Management on Internal Accounting Control (No. 1) .....	9550.01-06
642.59	Pre-Award Surveys (No. 1) .....	9642.01-03
642.59	Award Survey Made in Conjunction With an Audit (No. 2) .....	9642.04-05
642.60	Reporting on Internal Accounting Control "Compliance With the Currency and Foreign Transactions Reporting Act" (No. 12) .....	9642.39-41

<u>Section</u>	<u>Interpretation Subject (Interpretation No.)</u>	<u>Interpretation Section</u>
642.61	Reporting on Internal Accounting Control "Compliance With the Currency and Foreign Transactions Reporting Act" (No. 12) .....	9642.39-41
711.05	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1) .....	9711.01-11
711.10	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1) .....	9711.01-11
711.11	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1) .....	9711.01-11
711.12	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1) .....	9711.01-11
711.13	Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date (No. 1) .....	9711.01-11

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## AU Appendix E

# AICPA Audit and Accounting Guides and Statements of Position

### Audit and Accounting Guides

*Audit Sampling*, Statistical Sampling Subcommittee.

*Audits of Agricultural Producers and Agricultural Cooperatives*, Agribusiness Special Committee; *Statement of Position*, Accounting by Agricultural Producers and Agricultural Cooperatives, Accounting Standards Division, April 1985.

*Audits of Airlines*, Civil Aeronautics Subcommittee; *Statement of Position*, Accounting for Developmental and Preoperating Costs, Purchases and Exchange of Take-off and Landing Slots, and Airframe Modifications, Accounting Standards Division, September 1988.

*Audits of Banks*, Banking Committee; *Statement of Position*, Reporting by Banks of Investment Securities Gains or Losses, Accounting Standards Division, December 1983; *Statement of Position*, Definition of "Substantially the Same" for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position, Accounting Standards Division, February 1990; *Statement of Position*, Inquiries of Representatives of Financial Institution Regulatory Agencies, Committees on Banking, Credit Unions, and Savings and Loan Associations, August 1990; *Statement of Position*, Directors' Examinations of Banks, Committee on Banking, September 1990; *Statement of Position*, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets, Accounting Standards Executive Committee, November 1990; *Statement of Position*, Accounting for Foreclosed Assets, Accounting Standards Division, April 1992.

*Audits of Brokers and Dealers in Securities*, Subcommittee on Stockbrokerage Auditing; *Statement of Position*, Reports on Audited Financial Statements of Brokers and Dealers in Securities, Stockbrokerage and Investment Banking Committee, January 1989; *Statement of Position*, Reports on the Internal Control Structure in Audits of Brokers and Dealers in Securities, Stockbrokerage and Investment Banking Committee, April 1989; *Statement of Position*, Report on the Internal Control Structure in Audits of Futures Commission Merchants, Stockbrokerage and Investment Banking Committee, February 1990; *Statement of Position*, Definition of "Substantially the Same" for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position, Accounting Standards Division, February 1990.

*Audits of Casinos*, Gaming Industry Special Committee.

*Audits of Certain Nonprofit Organizations*, Subcommittee on Nonprofit Organizations; *Statement of Position*, Accounting Principles and Reporting Practices for Certain Nonprofit Organizations, Accounting Standards Division, December 1978; *Statement of Position*, Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal, Accounting Standards Division, August 1987.

**Audit and Accounting Guides—Continued**

*Audits of Colleges and Universities*, Committee on College and University Accounting and Auditing; *Statement of Position*, Financial Accounting and Reporting by Colleges and Universities, Accounting Standards Division, August 1974.

*Audits of Credit Unions*, Credit Unions Committee; *Statement of Position*, Inquiries of Representatives of Financial Institution Regulatory Agencies, Committees on Banking, Credit Unions, and Savings and Loan Associations, August 1990; *Statement of Position*, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets, Accounting Standards Executive Committee, November 1990; *Statement of Position*, Accounting for Foreclosed Assets, Accounting Standards Division, April 1992.

*Audits of Employee Benefit Plans*, Employee Benefit Plans Committee.

*Audits of Entities With Oil and Gas Producing Activities*, Oil and Gas Committee.

*Audits of Federal Government Contractors*, Defense Contractors Committee; *Statement of Position*, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, Accounting Standards Division, July 1981.

*Audits of Finance Companies* (Including Independent and Captive Financing Activities of Other Companies), Finance Companies Guide Special Committee; *Statement of Position*, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets, Accounting Standards Executive Committee, November 1990; *Statement of Position*, Accounting for Foreclosed Assets, Accounting Standards Division, April 1992.

*Audits of Investment Companies*, Investment Companies Special Committee; *Statement of Position*, Reports on Audited Financial Statements of Investment Companies, Investment Companies Committee, January 1989; *Statement of Position*, Report on the Internal Control Structure in Audits of Investment Companies, Investment Companies Committee, December 1989.

*Audits of Property and Liability Insurance Companies*, Insurance Companies Committee; *Statement of Position*, Reports on Audited Financial Statements of Property and Liability Insurance Companies, Insurance Companies Committee, November 1990; *Statement of Position*, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets, Accounting Standards Executive Committee, November 1990; *Statement of Position*, Accounting for Foreclosed Assets, Accounting Standards Division, April 1992; *Statement of Position*, Auditing Insurance Entities' Loss Reserves, Auditing Insurance Entities' Loss Reserves Task Force of the Insurance Companies Committee, May 1992; *Statement of Position*, Accounting for Foreign Property and Liability Reinsurance, Reinsurance Auditing and Accounting Task Force of the Insurance Companies Committee, June 1992.

*Audits of Providers of Health Care Services*, Health Care Committee; *Statement of Position*, Financial Accounting and Reporting by Providers of Prepaid Health Care Services, Accounting Standards Division, May 1989; *Statement of Position*, Financial Accounting and Reporting by Continuing Care Retirement Communities, Accounting Standards Division, November 1990.

**Audit and Accounting Guides—Continued**

*Audits of Savings Institutions*, Savings and Loan Associations Guide Special Committee.

*Audits of Service-Center-Produced Records*, Service-Center-Produced Records Task Force.

*Audits of State and Local Governmental Units*, State and Local Government Committee; *Statement of Position*, Auditor's Reports in Audits of State and Local Governmental Units, Auditing Standards Division, August 1989; *Statement of Position*, The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act, Government Accounting and Auditing Committee, November 1990.

*Audits of Stock Life Insurance Companies*,\* Committee on Insurance Accounting and Auditing; *Statement of Position*, Confirmation of Insurance Policies in Force, Auditing Standards Division, August 1978; *Statement of Position*, Auditing Life Reinsurance, Auditing Standards Division, November 1984; *Statement of Position*, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets, Accounting Standards Executive Committee, November 1990; *Statement of Position*, Accounting for Foreclosed Assets, Accounting Standards Division, April 1992.

*Audits of Voluntary Health and Welfare Organizations*, Committee on Voluntary Health and Welfare Organizations; *Statement of Position*, Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal, Accounting Standards Division, August 1987.

*Common Interest Realty Associations*, Common Interest Realty Associations Task Force.

*Computer-Assisted Audit Techniques*, Computer Services Executive Committee.

*Consideration of the Internal Control Structure in a Financial Statement Audit*.

*Construction Contractors*, Construction Contractor Guide Committee; *Statement of Position*, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, Accounting Standards Division, July 1981.

*Guide for Prospective Financial Statements*, Financial Forecasts and Projections Task Force; *Statement of Position*, Questions Concerning Accountants' Services on Prospective Financial Statements, Auditing Standards Division, April 1989; *Statement of Position*, Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations, Forecasts and Projections Task Force, January 1990; *Statement of Position*, Questions and Answers on the Term *Reasonably Objective Basis* and Other Issues Affecting Prospective Financial Statements, Auditing Standards Division, February 1992.

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\* Financial accounting and reporting principles and practices described in the indicated Audit and Accounting Guides and Statements of Position have been extracted by the FASB and issued as Statements of Financial Accounting Standards, which are enforceable under Rule 203 of the AICPA Rules of Conduct.

**Audit and Accounting Guides—Continued**

*Guide for the Use of Real Estate Appraisal Information*, Real Estate Committee; *Statement of Position*, Accounting for Foreclosed Assets, Accounting Standards Division, April 1992.

*Personal Financial Statements Guide*, Personal Financial Statements Task Force; *Statement of Position*, Accounting and Financial Reporting for Personal Financial Statements, Accounting Standards Division, October 1982.

**Statements of Position of the Auditing Standards Division**

<i>Confirmation of Insurance Policies in Force, Audits of Stock Life Insurance Companies</i> . . . . .	8/78
<i>Auditing Property and Liability Reinsurance</i> . . . . .	10/82
<i>Auditing Life Reinsurance</i> . . . . .	11/84
<i>Reports on Audited Financial Statements of Brokers and Dealers in Securities</i> . . . . .	1/89
<i>Reports on Audited Financial Statements of Investment Companies</i> . . . . .	1/89
<i>Questions Concerning Accountants' Services on Prospective Financial Statements</i> . . . . .	4/89
<i>Reports on the Internal Control Structure in Audits of Brokers and Dealers in Securities</i> . . . . .	4/89
<i>Auditor's Reports in Audits of State and Local Governmental Units</i> . . . . .	8/89
<i>Report on the Internal Control Structure in Audits of Investment Companies</i> . . . . .	12/89
<i>Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations</i> . . . . .	1/90
<i>Auditor's Reports Under U.S. Department of Housing and Urban Development "Audit Guide for Mortgagors Having HUD Insured or Secretary Held Multifamily Mortgages"</i> . . . . .	2/90
<i>Report on the Internal Control Structure in Audits of Futures Commission Merchants</i> . . . . .	2/90
<i>Inquiries of Representatives of Financial Institution Regulatory Agencies</i> . . . . .	8/90
<i>Directors' Examinations of Banks</i> . . . . .	9/90
<i>The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act</i> . . . . .	11/90
<i>Reports on Audited Financial Statements of Property and Liability Insurance Companies</i> . . . . .	11/90
<i>Questions and Answers on the Term Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements</i> . . . . .	2/92
<i>Auditing Insurance Entities' Loss Reserves</i> . . . . .	5/92

**Statements of Position of the Accounting Standards Division**

<i>Financial Accounting and Reporting by Colleges and Universities</i> . . . . .	8/74
<i>Accounting Practices of Real Estate Investment Trusts</i> . . . . .	6/75
<i>Accounting Practices for Certain Employee Stock Ownership Plans</i> . . . . .	12/76
<i>Accounting Practices of Real Estate Investment Trusts</i> . . . . .	5/78
<i>Accounting for Investments in Real Estate Ventures</i> . . . . .	12/78
<i>Accounting Principles and Reporting Practices for Certain Non-profit Organizations</i> . . . . .	12/78
<i>Accounting for Performance of Construction-Type and Certain Production-Type Contracts</i> . . . . .	7/81
<i>Accounting and Financial Reporting for Personal Financial Statements</i> . . . . .	10/82
<i>Reporting by Banks of Investment Securities Gains or Losses</i> . . . . .	12/83
<i>Accounting by Agricultural Producers and Agricultural Cooperatives</i> . . . . .	4/85
<i>Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal</i> . . . . .	8/87
<i>Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications</i> . . . . .	9/88
<i>Financial Accounting and Reporting by Providers of Prepaid Health Care Services</i> . . . . .	5/89
<i>Definition of the Term "Substantially the Same" for Holders of Debt Instruments as Used in Certain Audit Guides and a Statement of Position</i> . . . . .	2/90
<i>Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets</i> . . . . .	11/90
<i>Financial Accounting and Reporting by Continuing Care Retirement Communities</i> . . . . .	11/90
<i>Financial Reporting by Entities in Reorganization Under the Bankruptcy Code</i> . . . . .	11/90
<i>Software Revenue Recognition</i> . . . . .	12/91
<i>Accounting for Real Estate Syndication Income</i> . . . . .	2/92
<i>Accounting for Foreclosed Assets</i> . . . . .	4/92
<i>Accounting for Foreign Property and Liability Reinsurance</i> . . . . .	6/92

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## AU Appendix F

### *Schedule of Changes in Statements on Auditing Standards*

<i>Section</i>	<i>Par.</i>	<i>Changes</i>	<i>Date of Change</i>
110	.02	Amended <sup>†</sup>	April, 1989
110	.05-.08	Superseded by SAS 16	January, 1977
150	.06	Amended by SAS 43	August, 1982
160		Superseded by SAS 25	November, 1979
210	.05	Amended by SAS 5	July, 1975
230	.04	Amended by SAS 41	April, 1982
310	.02	Amended by SAS 45	August, 1983
310	.03	Amended by SAS 45	August, 1983
310	.05-.09	Superseded by SAS 45	August, 1983
311	.03	Amended by SAS 47	December, 1983
311	.03	Amended by SAS 48	July, 1984
311 *	.09	New paragraph added by issuance of SAS 48	July, 1984
311	.10	New paragraph added by issuance of SAS 48	July, 1984
312		Amended <sup>†</sup>	April, 1989
315	.11	Superseded by SAS 15	December, 1976
318	.07	Amended by SAS 48	July, 1984
318		Superseded by SAS 56	April, 1988
320 **	.03	Superseded by SAS 48	July, 1984
320	.32	Amended by SAS 3	December, 1974
320	.33	New paragraph added by issuance of SAS 48	July, 1984
320	.34	New paragraph added by issuance of SAS 48	July, 1984
320	.37	Amended by SAS 48	July, 1984
320	.50	Amended by SAS 43	August, 1982
320	.51	Amended by SAS 43	August, 1982
320	.52	Amended by SAS 43	August, 1982
320	.53	Amended by SAS 43	August, 1982
320	.54	Amended by SAS 43	August, 1982
320	.55	Amended by SAS 43	August, 1982

<sup>†</sup> Paragraphs reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

\* Section 311 paragraphs .09 through .13 renumbered .11 through .15 by issuance of Statement on Auditing Standards No. 48.

\*\* Section 320 paragraphs .56 through .75 renumbered .60 through .79 by issuance of Statement on Auditing Standards No. 43. Section 320 paragraphs .04 through .79 renumbered .03 through .84 by issuance of Statement on Auditing Standards No. 48.

<u>Section</u>	<u>Par.</u>	<u>Changes</u>	<u>Date of Change</u>
320	.56	Amended by SAS 43	August, 1982
320	.57	New paragraph added by issuance of SAS 48	July, 1984
320	.58	New paragraph added by issuance of SAS 48	July, 1984
320	.59	New paragraph added by issuance of SAS 43	August, 1982
320	.60	New paragraph added by issuance of SAS 43	August, 1982
320	.61	New paragraph added by issuance of SAS 43	August, 1982
320	.62	New paragraph added by issuance of SAS 43	August, 1982
320	.65	Amended by SAS 48	July, 1984
320	.66	New paragraph added by issuance of SAS 48	July, 1984
320	.67	Amended by SAS	July, 1984
320	.68	New paragraph added by issuance of SAS 48	July, 1984
320	.73	Amended by SAS 20	August, 1977
320	.73	Amended by SAS 30	July, 1980
320	.75	Amended by SAS 23	October, 1978
320	.77	Amended by SAS 39	June, 1981
320	.79	Superseded by SAS 9	December, 1975
320		Superseded by SAS 55	April, 1988
320A		Superseded by SAS 39	June, 1981
320B		Superseded by SAS 39	June, 1981
321		Superseded by SAS 48	July, 1984
322	.05	Superseded by SAS 55	April, 1989
322		Superseded by SAS 65	April, 1991
323	.01	Amended by SAS 24	March, 1979
323	.01	Amended by SAS 30	July, 1980
323	.08	Amended by SAS 30	July, 1980
323	.09	Amended by SAS 30	July, 1980
323		Superseded by SAS 60	April, 1988
324		Superseded by SAS 70	May, 1992
326 *	.12	New paragraph added by issuance of SAS 48	August, 1984
327	.08	Amended by SAS 30	July, 1980
327		Superseded by SAS 53	April, 1988
328		Superseded by SAS 54	April, 1988
330		Superseded by SAS 31	August, 1980
330		SAS 67 added	November, 1991
331	.01	Amended by SAS 67	November, 1991

\* Section 326 paragraphs .12 through .23 renumbered .13 through .24 by issuance of Statement on Auditing Standards No. 48.

<i>Section</i>	<i>Par.</i>	<i>Changes</i>	<i>Date of Change</i>
331	.03	Superseded by SAS 67	November, 1991
331	.04	Superseded by SAS 67	November, 1991
331	.05	Superseded by SAS 67	November, 1991
331	.06	Superseded by SAS 67	November, 1991
331	.07	Superseded by SAS 67	November, 1991
331	.08	Superseded by SAS 67	November, 1991
331	.14	Amended by SAS 43	August, 1982
331 *	.15	Deleted by SAS 43	August, 1982
331 ***	.15	Amended by SAS 2	December, 1974
332	.16	Amended by SAS 2	December, 1974
335	.01-.19	Superseded by SAS 45	August, 1983
338		Superseded by SAS 41	April, 1982
340		Superseded by SAS 59	April, 1988
341	.12	Amended by SAS 64	February, 1991
350		Amended †	April, 1989
350	.08-.09	Amended by SAS 45	August, 1983
350	.11	Amended by SAS 45	August, 1983
350	.46	Amended by SAS 43	June, 1982
350	.47	Amended by SAS 45	August, 1983
410	.02	Amended by SAS 14	December, 1976
410	.03-.04	Superseded by SAS 5	July, 1975
411	.05-.06	Amended by SAS 43	August, 1982
411	.05-.08	Amended by SAS 52	April, 1988
411 **	.07-.08	New paragraph added by issuance of SAS 43	August, 1982
411		Superseded by SAS 69	January, 1992
420	.08	Amended †	April, 1989
420 ***	.09	Added †	April, 1989
420 ***	.13	Added †	April, 1989
420 ***	.15	Amended by SAS 43	August, 1982
420 ***	.15	Deleted †	April, 1989
420	.16	Deleted by SAS 43	August, 1982
420 ***	.20	Deleted †	April, 1989
420	.23-.24	Added †	April, 1989
430	.04	Amended by SAS 21	December, 1977
430		Superseded by SAS 32	October, 1980
504	.20	Amended by SAS 35	April, 1981

\* Section 331 paragraph .16 (as amended by SAS 2) renumbered .15 by issuance of Statement on Auditing Standards No. 43.

† Paragraphs reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

\*\* Section 411 paragraphs .07 through .09 renumbered .09 through .11 by issuance of Statement on Auditing Standards No. 43.

\*\*\* Section 420 paragraphs .17 through .21 renumbered .16 through .20 by issuance of Statement on Auditing Standards No. 43. Paragraphs .09 through .11 renumbered .10 through .12, and paragraphs .12 through .20 renumbered .14 through .22 to reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.



<u>Section</u>	<u>Par.</u>	<u>Changes</u>	<u>Date of Change</u>
505	.05	Amended by SAS 43	August, 1982
505	.06	Amended by SAS 34	March, 1981
505	.13-.15	Superseded by SAS 26	November, 1979
505		Superseded by SAS 58	April, 1988
508	.83	Amended by SAS 64	February, 1991
509	.17	Amended by SAS 21	December, 1977
509	.18	Amended by SAS 5	July, 1975
509	.39	Amended by SAS 43	August, 1982
509	.45	Amended by SAS 26	November, 1979
509	.49	Superseded by SAS 15	December, 1976
509		Superseded by SAS 58	April, 1988
510		Superseded by SAS 2	December, 1974
511		Superseded by SAS 2	December, 1974
512		Superseded by SAS 2	December, 1974
513		Superseded by SAS 2	December, 1974
514		Superseded by SAS 2	December, 1974
515		Superseded by SAS 2	December, 1974
516	.02	Amended by SAS 2	December, 1974
516	.09	Amended by SAS 13	May, 1976
516	.09	Amended by SAS 24	March, 1979
516	.11	Amended by SAS 2	December, 1974
516	.11-.12	Superseded by SAS 15	December, 1976
516	.14	Amended by SAS 21	December, 1977
516		Superseded by SAS 26	November, 1979
517		Superseded by SAS 26	November, 1979
518	.03	Amended by SAS 14	December, 1976
518		Superseded by SAS 26	November, 1979
519		Superseded by SAS 24	March, 1979
534	.09-.10	Amended †	April, 1989
535		Superseded by SAS 2	December, 1974
540		Superseded by SAS 2	December, 1974
541		Superseded by SAS 2	December, 1974
542	.01-.04	Superseded by SAS 2	December, 1974
542		Superseded by SAS 58	April, 1988
543	.16	Amended by SAS 64	February, 1991
543	.18	Superseded by SAS 7	November, 1975
544	.01	Superseded by SAS 2	December, 1974
544	.02	Amended by SAS 2	December, 1974
544	.02	Amended by SAS 14	December, 1976
544	.04	Amended by SAS 14	December, 1976
545	.01	Amended by SAS 21	December, 1977
545	.05	Amended by SAS 21	December, 1977

† Paragraphs reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

<i>Section</i>	<i>Par.</i>	<i>Changes</i>	<i>Date of Change</i>
545		Superseded by SAS 58	April, 1988
546	.17	Amended by SAS 2	December, 1974
546		Superseded by SAS 58	April, 1988
547		Superseded by SAS 2	December, 1974
551	.15	Amended by SAS 52	April, 1988
552		Amended †	April, 1989
553	.02	Amended by SAS 33	October, 1980
553	.08	Amended by SAS 29	December, 1980
553	.11	Amended by SAS 29	December, 1980
553		Superseded by SAS 52	April, 1988
554		Superseded by SAS 52	April, 1988
555	.01-.06	Superseded by SAS 45	August, 1983
556		Superseded by SAS 52	April, 1988
557		Superseded by SAS 52	April, 1988
560	.12d	Amended by SAS 12	January, 1976
610		Superseded by SAS 29	December, 1980
620		Superseded by SAS 14	December, 1976
621	.05	Amended by SAS 35	April, 1981
621	.15-.17	Superseded by SAS 35	April, 1981
621		Superseded by SAS 63	April, 1989
630		Superseded by SAS 38	April, 1981
631	.47	Amended by SAS 43	August, 1982
631	.51	Amended by SAS 43	August, 1982
631	.56	Amended by SAS 43	August, 1982
631		Superseded by SAS 49	September, 1984
634	.33	Deleted †	April, 1989
634	.55	Deleted †	April, 1989
640	.01	Amended by SAS 20	August, 1977
640	.12-.13	Amended by SAS 20	August, 1977
640		Superseded by SAS 30	July, 1980
641		Superseded by SAS 30	July, 1980
642	.02	Amended by SAS 44	December, 1982
642	.47-.53	Superseded by SAS 60	April, 1988
642	.60	Amended by SAS 44	December, 1982
710	.11	Amended by SAS 15	December, 1976
710		Superseded by SAS 37	April, 1981
720	.22	Amended by SAS 13	May, 1976
720		Superseded by SAS 24	March, 1979
721	.02	Amended by SAS 26	November, 1979
721		Superseded by SAS 36	April, 1981
722	.01-.02	Amended by SAS 66	June, 1991

† Paragraphs reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

<u>Section</u>	<u>Par.</u>	<u>Changes</u>	<u>Date of Change</u>
722 ††	.03-.04	New paragraphs added by issuance of SAS 66	June, 1991
722 ††	.31	Amended by SAS 66	June, 1991
722 ††	.32	Deleted by SAS 66	June, 1991
722 ††	.33-.35	New paragraphs added by issuance of SAS 66	June, 1991
722		Superseded by SAS 71	May, 1992
730		Withdrawn by Auditing Standards Board	April, 1981
801		Superseded by SAS 68	November, 1991
901	.01	Amended by SAS 43	August, 1982
901 *	.02	Deleted by SAS 43	August, 1982
901	.03	Deleted by SAS 43	August, 1982
901	.04	Deleted by SAS 43	August, 1982
901	.05	Deleted by SAS 43	August, 1982
901	.14	Amended †	April, 1989
901	.24	Amended by SAS 43	August, 1982
901	.28	Amended by SAS 43	August, 1982

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†† Section 722, paragraphs .03 through .31 and .33 renumbered .05 through .32 and .36 through .37, respectively, by the issuance of SAS No. 66.

\* Section 901 paragraphs .06 through .32 renumbered .02 through .28 by issuance of SAS No. 43.

† Paragraphs reflect the conforming changes necessary due to the issuance of SAS Nos. 53 through 62.

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